LC Paper No. CB(1)480/12-13(02)

Ref: CB1/BC/2/12

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

Background brief

Purpose

This paper provides background information on the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 ("the Bill"), and a summary of major views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") on related issues during discussions at meetings in the 2011-2012 and 2012-2013 sessions.

Background

Islamic finance and Islamic bonds

2. Islamic finance refers to the financial activities that are consistent with the principles of Islamic law, known as Shariah. Shariah is based on the text of Quran (considered by Muslims as the revealed word of God) and the Sunnah (the sayings and practices of Prophet Muhammad). Shariah provides guidance or principal rules governing all aspects of the day-to-day activities of Muslims, including religion, politics, finance, business and family. Major principles of Shariah that are applicable to Islamic finance include Riba (prohibition on receipt and payment of interest) and Haram (prohibition on dealing in banned activities e.g. alcohol and pork). According to the Administration, Islamic finance is among the fastest growing segments in the international financial system, with a presence in both Muslim and non-Muslim communities. Islamic finance assets have grown from US$150 billion in the mid-1990s to US$1.3 trillion in 2011, and the number of Islamic financial institutions has increased to over 600 in more than 75 economies.

3. Islamic bond ("sukuk") is a common type of financial instrument used for Islamic financing. Sukuk are investment certificates economically equivalent to bonds. Unlike bonds, which are debt-based instruments that pay interest, sukuk are asset-backed or asset-based instruments and represent the ownership by the sukuk holders in the underlying pool of tangible assets. Sukuk holders are entitled to a share in the revenues generated and the capital appreciation of the assets involved. Sukuk can be issued by governments or private companies.

The Administration's initiatives to develop Islamic finance

4. The policy initiative of developing Islamic finance in Hong Kong was first unveiled by the Chief Executive in his 2007-2008 Policy Address and also enshrined in the Policy Addresses and the Financial Secretary's Budgets in the subsequent years. According to the Administration, the development of Islamic finance in Hong Kong could help diversify Hong Kong's financial platform and enhance its competitiveness as an international financial centre. 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 the rapidly expanding market of sukuk.

5. While the development of a local sukuk market would serve as the first step of promoting the development of Islamic finance in Hong Kong, the existing tax regime of Hong Kong is a major impediment to the development of a sukuk market. This is because the structuring of sukuk often involved 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. The Administration therefore considers it necessary to introduce amendments to the Inland Revenue Ordinance (Cap. 112) ("IRO") and Stamp Duty Ordinance (Cap. 117) ("SDO") to level the playing field for common types of sukuk vis-à-vis conventional bonds in terms of profit tax, property tax and stamp duty liabilities. The Administration launched a two-month public consultation on the proposed legislative amendments in March 2012. According to the Administration, a large majority of the respondents to the consultation exercise welcomed the legislative objectives and proposal, with a view to enhancing Hong Kong's competitiveness in financial services and enabling Hong Kong as a gateway for international Islamic finance. On 29 October 2012, the Administration issued a Consultation Conclusion to address the suggestions and comments from the respondents.

The Bill

6. The Administration introduced the Bill into the Legislative Council ("LegCo") on 28 December 2012. The Bill seeks to amend IRO to accord specified arrangements with tax treatment as debt arrangements, amend SDO to provide stamp duty relief for certain transactions under such specified arrangements, and provide for incidental and consequential matters. The Bill adopts a religion-neutral approach in drafting, which is modeled on the same approach taken by the UK. The term "alternative bond scheme" ("ABS"), instead of "sukuk", is used to denote the specified arrangements to which the proposed tax treatment shall apply. The Bill provides that an ABS contains a "bond arrangement" and an "investment arrangement". Four types of investment arrangement are specified in the Bill, i.e. a lease arrangement, a profit sharing arrangement, a purchase and sale arrangement, and an agency arrangement. These arrangements correspond to the different underlying structures by which investment return is generated in five most common types of sukuk, i.e. Ijarah, Musharakah, Mudarabah, Murabahah, and Wakalah. An ABS has to satisfy certain conditions ("qualifying conditions") in order to be treated as a "debt arrangement" and be eligible for the proposed tax treatment under the Hong Kong tax laws. The details are as follows:

(a) <u>A bond arrangement</u> must comply with five conditions –

  (i) "reasonable commercial return" condition;

  (ii) "bond arrangement as financial liability" condition;

  (iii) "Hong Kong connection" condition;

  (iv) "maximum term length" condition; and

  (v) "arrangements performed according to terms" condition.

(b) <u>An investment arrangement</u> must comply with two conditions –

  (i) "bond-issuer as conduit" condition; and

  (ii) "investment arrangement as financial liability" condition.

7. The main provisions of the Bill are as follows-

<u>Amendment to IRO</u>

(a) Clause 4 introduces new Schedule 17A to IRO which contains the following provisions –

(i) sections 2 to 9 reflect the specific sukuk types covered by the proposed scheme by defining an ABS and describing the relevant types of underlying structures;

(ii) sections 10 and 11 set out the formulae in accordance with which the investment return of the schemes is calculated for tax purpose;

(iii) sections 12 to 19 set out the qualifying conditions for a bond arrangement and an investment arrangement within a specified ABS to qualify for the proposed tax treatment;

(iv) sections 20 and 21 set out the proposed tax treatment for a qualified bond arrangement and a qualified investment arrangement in a specified ABS respectively;

(v) section 22 empowers the Financial Secretary to amend, by way of subsidiary legislation, certain provisions of the Schedule to add new specified investment arrangements, to provide for the calculation of the investment return, and to specify certain asset transactions under a specified investment arrangement for the purpose of the proposed tax treatment; and

(vi) sections 23 to 28 provide for record-keeping, notifications, assessments and other miscellaneous matters.

<u>Amendments to SDO</u>

(b) Clauses 21, 22 and 23 add new Parts VA, VB and Schedule 6 to SDO, which contains the following provisions –

(i) sections 47C and 47D ensure that the product coverage and qualifying conditions in relation to stamp duty relief for a specified ABS will be basically the same as those set out in the proposed Schedule 17A to IRO;

(ii) sections 47E and 47F set out the proposed stamp duty relief for a qualified bond arrangement and a qualified investment arrangement in a specified ABS subject to an additional requirement for provision of security;

(iii) section 47G, together with the new Schedule 6, relates to the application of sections 29CA and 29DA of SDO in relation to special stamp duty liability for relevant transactions underlying a specified ABS which involve a residential property; and

(iv) sections 47H to 47L provide for record-keeping, notifications, assessments and other miscellaneous matters;

(c) For the sake of consistency, new section 47L will apply to the making of an assessment upon a deemed withdrawal of stamp duty relief under existing section 45 (relief in case of conveyance from one associated body corporate to another) apart from the proposed section 47H under SDO;

Other amendments

(d) Clauses 17, 20, 33 and 35 are transitional provisions; and

(e) Clauses 5-16, 18-19, 24-32 and 34 deal with some minor technical and consequential amendments.

Major views and concerns expressed by members during discussion at meetings of the Panel on Financial Affairs

8. The Administration briefed FA Panel on the proposed framework and schedule of the legislative exercise to amend IRO and SDO at the meeting on 3 May 2010. It further briefed Panel members at the meeting on 5 November 2012 on the legislative proposals of the Bill. Members in general expressed support for the Administration's initiative to develop an Islamic financial market in Hong Kong and had no objection to the Administration introducing the Bill into LegCo. Major views and concerns expressed by members during the discussions are summarized in the ensuing paragraphs.

Development of Islamic finance in Hong Kong and infrastructural support

9. Members urged the Administration to step up efforts in the development of Islamic finance in Hong Kong in order not to lag behind development of major financial centres such as Kuala Lumpur, Singapore, London and New York. Members considered that the Administration should formulate a strategy for the development of Islamic finance in Hong Kong which would facilitate the development of Islamic financial products apart from bonds, and devise measures to nurture adequate professionals and market practitioners with knowledge of Shariah in Hong Kong to support the development of Islamic finance and handle sukuk-related disputes. Reference should be made to the efforts of other jurisdictions like Singapore, in this regard. In view of the small size of local Muslim community, some members considered it necessary for the Administration to put in place both relevant financial and cultural infrastructures

(e.g. Muslim schools and mosques) to meet the needs and nurture the growth of the Muslim investor segment.

10. Regarding the Government's strategy to develop Islamic finance, the Administration explained that given the small Islamic population in Hong Kong, the Administration would concentrate on the development of a wholesale capital Islamic financial market instead of retail Islamic services. The development of Islamic finance was expected to enhance the competitiveness of Hong Kong's financial services industry in diversifying the scope of products and services to cater for the needs of local and international investors.

11. On the training of professionals, the Administration responded that it was fully aware of the need for provision of professionals and market practitioners with expertise in Islamic finance and had been working in this direction on various fronts. Hong Kong Monetary Authority ("HKMA") supplemented that it had been in close cooperation with the Treasury Markets Association in organizing seminars and workshops on Islamic finance from time to time and had signed a Memorandum of Understanding with the Dubai International Financial Centre Authority and Bank Negara Malaysia respectively in May 2008 and September 2009 to strengthen cooperation in the development of Islamic finance. HKMA was also an associate member of the Islamic Financial Services Board and participated in the seminars and workshops organized by the Board from time to time to grasp the latest developments of Islamic finance globally.

<u>Legal framework and handling of sukuk-related disputes</u>

12. Noting that sukuk was based on the principles of Islamic law, members expressed concern about whether the laws of Hong Kong or the Islamic law would prevail in the event of sukuk-related disputes, and the possible risks of conflicting with the Basic Law.

13. The Administration responded that the Bill would be religion-neutral and religious issues over the interpretation and application of Shariah underlying sukuk would be a matter for sukuk issuers and their legal expertise to deal with. The Administration further took note of members' suggestions on the need to make reference to overseas experience in tax reform to facilitate Islamic finance transactions and to adopt relevant initiatives as appropriate; as well as to consult relevant bodies, such as The Law Society of Hong Kong and the Hong Kong International Arbitration Centre, on matters regarding the mechanism and expertise for resolving conflicts/disputes relating to sukuk transactions.

<u>Investor protection</u>

14. Given the complicated and innovative nature of sukuk, members were concerned about protection for sukuk investors and considered that the sale of

sukuk should be restricted to professional investors only or even prohibited from retail buyers. Pointing out that sukuk were usually structured with special purpose vehicles set up offshore, the Administration/regulatory authorities was urged to exercise vigilance in risk management having regard to the credit rating of issuer/product where applicable. There was also concern about the absence of a uniform regulatory regime for Islamic finance in Hong Kong which might result in difficulties for investors to seek remedy in default cases involving Islamic financial institutions/products.

15. The Administration responded that similar to other financial products, sukuk were subject to the prevailing regulatory regime in respect of product offering, marketing and disclosure requirements in accordance with the relevant provisions of the Securities and Futures Ordinance (Cap. 571) and the Companies Ordinance (Cap. 32). It was observed that sukuk were more commonly sold to institutional investors than retail buyers. The Administration stressed that it would work together with relevant regulators to strengthen investor protection.

Proposed qualifying conditions for tax relief

16. One of the proposed qualifying conditions for tax relief was the "reasonable commercial return" condition (i.e. both the maximum total amount of the bond return that might 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 reasonable commercial return on money borrowed of the amount of the bond proceeds). Some members expressed concern that this condition was too stringent and might undermine the attractiveness of sukuk to investors. There was a view that flexibility should be provided to cater for the possible extent of investment return from leveraged lease arrangement in sukuk products.

17. The Administration responded that the "reasonable commercial return" condition was designed to prevent abuse by issuers to seek the proposed tax treatment for equity sukuk whose returns could be very different from those of conventional bonds, and to ensure that the prospective sukuk product was economically equivalent to a typical conventional bond structure for determining the tax treatment. In practice, the Inland Revenue Department would refer to the information in the offering documents of a sukuk product on the maximum rate of bond return payable to bond-holders and compare it with potential return from conventional bonds of comparable principal, product tenure and credit rating of issuer at the time of issue of the sukuk. In the event that the total amount of the bond return payable to sukuk-holders was abnormally higher than a reasonable commercial return of conventional bonds, the sukuk in question would be likely in the nature of equity and would not be deemed equivalent to a typical conventional bond structure and hence not eligible for the proposed tax treatment. The subsequent trading of the sukuk

and their price fluctuations in the secondary market would not impact on the satisfaction of the condition.

Prevention of tax avoidance

18. In response to members' enquiry about measures to address tax avoidance concerns, the Administration advised that besides requirement for a prospective sukuk to meet a set of qualifying conditions in ensuring that it was economically equivalent to a typical conventional bond structure before it could be eligible for the proposed tax treatment, a reasonable record-keeping period would be imposed on any originator or bond-issuer of the sukuk eligible for the tax relief. These parties would also be obliged to inform Commissioner of Inland Revenue or the Collector of Stamp Revenue (as the case required) of any disqualifying event, which might lead to withdrawal of the relief granted in its entirety under IRO or SDO. A security would 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. The Bill would have provisions on relevant assessment and procedural matters to prevent tax evasion.

Supplementary information provided by the Administration

19. At the meeting on 5 November 2012, members requested the Administration to provide supplementary information on aspects including, economic benefits and risks in relation to the development of a sukuk market, experiences of other financial markets in their tax law reforms to facilitate sukuk issuances, regulatory regime of sukuk such as handling of sukuk-related disputes and protection for sukuk investors, operation of the proposed "reasonable commercial return" condition, financial infrastructures to facilitate the development of a sukuk market in Hong Kong, and details of the responses received during the public consultation exercise conducted in May 2012. The information paper provided by the Administration was issued on 3 January 2013 vide LC Paper No. CB(1)372/12-13, of which the hyperlink is set out in the **Appendix**.

References

20. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
28 January 2013

Appendix

List of relevant papers

Date	Event	Papers/Minutes of meeting
3 May 2010	The Panel on Financial Affairs ("FA Panel") discussed the proposed amendments to the Inland Revenue Ordinance (Cap. 112) and Stamp Duty Ordinance (Cap. 117) in relation to Islamic finance	Discussion paper (LC Paper No. CB(1)1728/09-10(04)) Fact sheet on overview of Islamic finance (FS19/09-10) Minutes of meeting (LC Paper No. CB(1)2143/09-10) Follow-up paper (LC Paper No. CB(1)1902/09-10(01))
29 March 2012	The Administration launched a consultation on the proposed legislative amendments to facilitate the development of Islamic bond market in Hong Kong	Press release Consultation paper
29 October 2012	The Administration issued a consultation conclusion to the consultation exercise	Press release Consultation conclusion
5 November 2012	FA Panel discussed the legislative proposals of the Bill	Discussion paper (LC Paper No. CB(1)91/12-13(02)) Minutes of meeting (LC Paper No. CB(1)359/12-13) Follow-up paper (LC Paper No. CB(1)372/12-13(02))
9 January 2013	The Bill was introduced in to the Legislative Council	The Bill Legislative Council Brief Legal Service Division report (LC Paper No. LS 16/12-13)