For information

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

Follow-up Actions arising from
the Meeting on 29 January 2013

This paper sets out the following supplementary information in relation to the Bills Committee's discussions at the meeting on 29 January 2013 –

(a) the outcome of a consultation exercise, conducted by the Administration in March 2012, on this legislative proposal before the Bill was introduced into the Legislative Council in January 2013;

(b) the tax law reforms in relevant jurisdictions to facilitate the development of Islamic bond (sukuk) markets; and

(c) the investment environment for sukuk in Mainland financial markets.

Public Consultation on the Legislative Proposal

2. As mentioned in paragraph 20 of the Legislative Council brief issued on 24 December 2012[1] on the Bill, 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. Both the consultation paper and the consultation conclusion are published on the website of the Financial Services and the Treasury Bureau[2].

[1] File Ref: B9/33/2C
[2] http://www.fstb.gov.hk/fsb/ppr/consult/consult_sukuk.htm

3. A large majority of respondents welcomed the legislative objectives and proposal, with a view to enhancing Hong Kong's competitiveness in financial services and asset management, as well as enabling Hong Kong as a gateway for international Islamic finance. They were also in support of the proposed religion-neutral approach in drafting this Bill.

4. The Administration has considered all comments received carefully, and balanced them against relevant perspectives (in terms of market development, evolving market needs, and anti-tax avoidance policy considerations). Subsequently, the Bill has taken on board comments on several major issues as broadly set out below –

Coverage

(a) **Agency arrangement** *(section 9 of Schedule 17A to the Inland Revenue Ordinance, "IRO")*: Apart from the four most common types of sukuk in the global market[3], the coverage of the proposed tax framework is widened to cover "*Wakalah*" (agency arrangement), which is becoming increasingly popular in the global sukuk market;

(b) **Flexibility of the coverage of "specified investment arrangement"** *(section 22 of Schedule 17A to IRO)*: The market pointed out to us that our tax laws should allow flexibility to accommodate other types of sukuk as they become popular, in order not to hinder market development. Accordingly, the Bill proposes a clause to empower the Financial Secretary to expand the coverage of "specified investment arrangement" to respond to evolving market developments, by way of subsidiary legislation in future;

[3] These four types of sukuk include "*Ijarah*" (lease arrangement), "*Musharakah*" and "*Mudarabah*" (both being profits sharing arrangements), as well as "*Murabahah*" (purchase and sale arrangement). In the Bill, they are covered in sections 6-8 of Schedule 17A to IRO.

Qualifying Conditions

(c) **<u>Hong Kong connection condition</u>** *(section 15 of Schedule 17A to IRO)*: We include an additional route to enable a specified alternative bond scheme ("ABS") to comply with this condition, if the alternative bonds in question are "lodged with and cleared by the Central Moneymarkets Unit operated by the Monetary Authority";

(d) **<u>Maximum term length condition</u>** *(section 16 of Schedule 17A to IRO)*: We agree to market's view to further relax the condition to allow a specified ABS to be eligible for the proposed tax treatment if its specified term is not longer than 15 years;

(e) **<u>Removal of "diverse holding condition"</u>**: We agree to remove a condition to require an issuer to account for the holding situation[4] of the alternative bonds in question. This should help reduce compliance costs on issuers; and

Tax Administration Matters

(f) **<u>Record-keeping requirements</u>** *(section 24 of Schedule 17A to the IRO, and section 47J of Stamp Duty Ordinance ("SDO"))*: We have further relaxed the relevant requirements[5], without unduly restricting the power of the Commissioner of Inland Revenue ("CIR") / Collector of Stamp Revenue ("CSR") to pursue necessary assessment work and tackle tax avoidance.

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4 In the Consultation Paper, we had hitherto proposed that not more than 50% of the alternative bonds under an ABS were to be beneficially held, or were acquired with funds provided, directly or indirectly, by an originator, a bond issuer and their associated persons. We have removed this previously proposed condition, having regard to the market feedback.

5 For the purposes of the IRO, the Bill requires relevant documents to be kept until the expiry of three years after the end of the ABS term or the expiry of seven years after the relevant transaction, whichever is the later. For the purposes of the SDO, the Bill requires relevant documents to be kept until the expiry of one year after the end of the ABS term.

5. To facilitate implementation of the Bill after its enactment, and to address views expressed during the consultation exercise, CIR / CSR will be prepared to issue Interpretation and Practice Notes in relation to tax matters concerning sukuk. CIR / CSR will take the opportunity to clarify detailed operational matters in connection with, for example, withdrawal of tax benefits due to a breach of qualifying condition (section 12 of Schedule 17A to IRO), the reasonable commercial return condition (section 13 of Schedule 17A to IRO), additional assessments and tax refunds (section 26 of Schedule 17A to IRO), as well as the proposed security arrangement for stamp duty determination and charge under the SDO (section 47F(3) of SDO).

Tax Reforms in Other Jurisdictions on Sukuk

6. Malaysia, the United Kingdom, Singapore and Japan 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 and sukuk in terms of tax treatment, or to provide other types of tax reliefs or incentives. The coverage of 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.

7. As the taxation frameworks in different tax jurisdictions and legal systems vary to a considerable extent, a direct comparison may not be suitable. At the Bills Committee’s request, the Administration has, however, taken the liberty of preparing a table at **Annex** to set out our own understanding of tax reforms taken in the aforesaid jurisdictions, in order to illustrate the importance of our tax rules catching up with this rapidly expanding global market of sukuk.

Investment Environment for Sukuk in Mainland financial markets

8. We understand from practitioners that individual cities on the Mainland, such as Ningxia, are developing their markets for retail Islamic banking services. We are also aware that some overseas issuers have issued, or are interested in issuing, sukuk denominated in Renminbi[6] to match investment demands of relevant investors and financing needs of the originators concerned. We are not in a position to comment on issuing or investment activities of individual investment entities and sovereign wealth funds operating on the Mainland. Generally the investment environment for sukuk in individual market will depend on a range of circumstances including investors' appetite, market conditions, and financial infrastructure.

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

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[6] For examples, we note that two issuers in Malaysia have issued *Wakalah* sukuk (denominated in Renminbi) respectively in the last two years, raising funds of about 1.5 billion yuan in total from the global markets.

Annex: Tax Reforms in Other Jurisdictions on Sukuk[7]

	Malaysia	**United Kingdom**	**Singapore**	**Japan**
Scope covered by income tax legislation	All Islamic securities.	All listed sukuk in relation to transactions between a sukuk-issuer and sukuk holders for income tax purposes; and listed *Ijarah* sukuk in relation to transfers of underlying assets between an originator and a sukuk-issuer for capital allowances and capital gain tax purposes.	Debt securities, endorsed by *Shariah* council or body and issued by any financial institution in Singapore or any financial sector incentive (Islamic Finance) company, to be treated as "qualifying debt securities" ("QDS"); and certain approved Islamic debt securities arrangements (currently covering *Ijarah* sukuk with immovable property in Singapore as underlying asset only).	*Ijarah* sukuk.

[7] All information compiled in this comparison table is obtained through a desktop research exercise by the Administration from various sources available in the public domain or internet. The Administration has not been able to verify the information concerned against primary documents in overseas tax laws. We believe a direct comparison may not be suitable as the taxation frameworks and legal systems in different jurisdictions vary to a considerable extent.

	Malaysia	**United Kingdom**	**Singapore**	**Japan**
Income Tax Treatments	Debt sukuk are treated similarly like conventional bonds. Profit payments in lieu of interest are treated as interest (i.e. tax deductible for sukuk issuers, and taxable income to sukuk holders). Any underlying asset transactions for the purposes of *Syraiah* compliance are ignored for tax purposes. Islamic securities adopting the principles of *Mudharabah*, *Musyarakah*, *Ijarah* or *Istisna* approved by relevant authorities: the special purpose vehicle (i.e. sukuk-issuer) is disregarded for tax purposes and its income is treated as the income of the originator.	Returns payable on debt sukuk are treated as interest for tax purposes and hence tax deductible in arriving at the profits chargeable to tax. Transfers of underlying assets between an originator and a sukuk-issuer are disregarded for capital gains tax and capital allowances purposes.	Sukuk that constitute QDS are accorded a concessionary tax treatment that QDS enjoy. Any amount payable to any person from Islamic debt securities which are QDS are exempt from tax, provided the amount payable is not deductible against any income of the issuer derived in Singapore. Income derived by the special purpose vehicle under an approved Islamic debt securities arrangement are deemed as income derived at the end of the arrangement by the originator.	Certain withholding, capital gain, and corporate taxes are exempt in relation to profit distribution and redemption gain.
Scope covered by stamp duty legislation	All Islamic securities approved by relevant authorities.	Listed sukuk.	Approved Islamic debt securities arrangements (currently covering *Ijarah* sukuk with immovable property in Singapore as underlying asset only).	*Ijarah* sukuk.

	Malaysia	United Kingdom	Singapore	Japan
Stamp Duty Treatments	Stamp duty exemption to any additional instruments for *Syraiah* compliance and to issue and trading of sukuk.	Issuance and trading of debt sukuk are not subject to stamp duty and stamp duty reserve tax. Listed *Ijarah* sukuk: (a) transfers of lands between originator and sukuk issuer, and (b) issue, transfer and redemption of sukuk are exempt from stamp duty land tax.	Instrument relating to approved Islamic debt securities arrangement: remission of all stamp duty chargeable in excess of S$500.	Certain registration tax and real property acquisition tax are not chargeable.
Other Tax Incentives	Some other initiatives, such as tax exemption to "interest" received from non-ringgit Islamic securities, extension of tax deduction on issuance costs of Islamic securities, and tax exemption to arrangers, underwriters and distributors of non-ringgit sukuk and Islamic fund management companies.	Apparently not available.	Apparently not available.	Apparently not available.