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For the attention of: Mr. Hugo Chiu

By email: [slchan@legco.gov.hk](mailto:slchan@legco.gov.hk)

Dear Sir,

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

Thank you for your letter dated 4 February 2013 inviting us to make a submission to the Bills Committee on the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 (the "Bill").

We understand that the main purpose of the Bill is to amend the Inland Revenue Ordinance ("IRO") and Stamp Duty Ordinance ("SDO") to provide a comparable taxation framework for some common types of Islamic bonds, vis-à-vis conventional bonds.

Given the above, we consider that the enactment of the Bill is in Hong Kong's interests and we support the same.

The following are our comments on some of the provisions of the Bill. Our comments necessarily consider the explanations given in the published conclusions of the consultation on the proposed legislation undertaken prior to drafting of the Bill (the "Consultation").

We do not plan to give an oral presentation to the Bills Committee. However, we would be happy to address any questions you may have on our written submission or address any questions from the Bills Committee if specifically requested to do so.

*All legislative references are to the Bill unless otherwise stated.*

**(1) 'Maximum term length condition' of 15 years for an alternative bond scheme**

We welcome the increase of the 'maximum term length condition' in Part 2, Clause 4, section 16 of the Bill to 15 years from the 10 years proposed in the Consultation. In our view, this increase is a helpful step towards comparable treatment for conventional bonds and alternative bond schemes ("ABS") and should help to differentiate Hong Kong from other jurisdictions with shorter maximum term length conditions.

However, some other jurisdictions, such as Singapore, do not have any maximum term length condition and for this reason may be favored over Hong Kong when issuing longer term ABS. We urge the Bills Committee to consider eliminating the 'maximum term length condition' as there is no such condition in relation to conventional bonds and it is therefore an impediment to the legislation achieving its stated aim of providing a comparable taxation framework for some common types of Islamic bonds, vis-à-vis conventional bonds.

**(2) 'Reasonable commercial return condition' for an alternative bond scheme**

We understand from the published conclusions of the Consultation that “[the] intention is to screen out, via this condition, equity or equity-like sukuk, so that the tax benefits will only be shared by sukuk economically equivalent to debt securities common in markets”. While this may be the intention, in our view what are referred to in the published conclusions of the Consultation as the ‘maximum return payable test’ and the ‘actual return paid test’ could apply more widely than intended and catch a significant number of ABS that do not provide an equity or equity-like return.

The published conclusions of the Consultation stress that the “IRD will apply the test to exclude sukuk with [a] return which is blatantly above what will be a reasonable commercial return for a debt security, or which is linked to profits”. Further, we understand that the Inland Revenue Department (the “IRD”) will issue guidance clarifying the types of returns which it considers to be caught by the tests. However, this approach may lead to an overreliance by taxpayers on IRD guidance, which is not binding on the IRD or the Hong Kong courts.

This approach may give rise to significant taxpayer uncertainty where an ABS appears to be caught by the ‘maximum return payable test’ or the ‘actual return payable test’, but it is not clear from the IRD guidance whether the IRD will challenge the ABS under either test.

We appreciate that in such a situation, taxpayers may mitigate this uncertainty by applying for a ruling under section 88A of the IRO, and we welcome the ability to do so. However, the tests under the ‘reasonable return condition’ are drafted widely enough that a significant number of taxpayers may face uncertainty and accordingly seek IRD rulings. This is likely to place additional pressure on IRD resources and make issuing sukuk from Hong Kong more expensive and time consuming and undermine the advantages of legislating for the taxation of sukuk rather than relying on rulings as is currently possible in any case.

We would therefore urge the Bills Committee to consider redrafting the ‘reasonable return condition’, such that its wording better reflects its intended application. This should provide both clarity on the application of the legislation and reduce the administrative burden of applying the legislation for the taxpayer and the IRD.

**(3) Retroactive withdrawal of tax treatment**

The published conclusions of the Consultation emphasized the need to prevent the use of the provisions of the Bill for tax avoidance. However, the retroactive disqualification of an ABS, as though it had never constituted a qualified bond or qualified investment arrangement (see Part 2, Clause 4, section 12(3) and (4) respectively), may have unintended consequences beyond deterring tax avoidance.

The Bill does not limit retroactive disqualification of ABS to cases of tax avoidance and so arrangements that are disqualified due to unavoidable commercial circumstances will be treated in the same manner as tax avoidance arrangements and penalized.

The published conclusions of the Consultation differentiate the Bill from the United Kingdom’s Alternative Finance Rules (“UK AFA Rules”), on which the Bill is modeled, on the basis that the Bill applies to listed and unlisted arrangements whereas the UK AFA Rules only apply to listed arrangements. The conclusions of the Consultation appear to justify the need for retroactive disqualification of ABS on the basis that unlisted ABS are more likely to be disqualified or perhaps they are more likely to be used for tax avoidance.

We would urge the Bills Committee to consider eliminating the retroactive disqualification of ABS entirely as it creates significant uncertainty and risk for taxpayers. If this is not considered possible, the Bills Committee may consider eliminating retroactive disqualification in respect of listed ABS, which should bring the Bill more closely in alignment with the UK AFA Rules.

We consider that the current drafting of the Bill with regard to retroactive disqualification of ABS may discourage taxpayers from Hong Kong sukuk issuances, particularly where they have the choice of issuing from another jurisdiction.

#### **(4) Additional profits tax assessment**

Many respondents to the Consultation felt that the time periods for making profits tax assessments or additional assessments in respect of ABS (see Part 2, Clause 4, section 26(3)) may put ABS at a disadvantage to conventional bonds.

We note that the published conclusions of the Consultation consider the need for this measure, citing in particular, the need to prevent tax avoidance through the use of unlisted ABS.

We would encourage the Bills Committee to limit any anti-avoidance measures or increase in profits tax assessment periods to only unlisted ABS. This should allow the IRD to counteract tax avoidance executed through the use of unlisted ABS, while easing the administrative burden on listed ABS, which are perceived as lower risk with regard to tax avoidance.

#### **(5) Need for prevention of tax avoidance**

Our comments in (1), (2), (3) and (4) above all relate to provisions that restrict or remove the application of the legislation to certain arrangements, ostensibly, to prevent use of the provisions in the Bill for tax avoidance. We would note that the legislation has largely been modeled on the UK AFA Rules. As the UK did not, at the time of introduction of the UK AFA Rules, have a general anti-avoidance provision and relied on detailed legislative provisions and targeted anti-avoidance rules to prevent tax avoidance, their legislation in this area of revenue law is necessarily lengthy and complex.

The Bill adopts similar detailed legislative provisions and inclusion of targeted anti-avoidance rules to the UK despite the IRO containing deterrents and prevention of tax avoidance through the general anti-avoidance provisions in sections 61 and 61A.

We would strongly urge the Bills Committee to consider paring back the legislation in this regard as sections 61 and 61A of the IRO should provide adequate (and arguably more effective) safeguards against tax avoidance. The Bill as it stands will introduce a further 28 sections to the IRO and amend numerous others, which we consider to be excessive in light of the length of the IRO as a whole. Furthermore, paring back the detailed legislative provisions and targeted anti-avoidance rules in the Bill should address the concerns we express in (1), (2), (3) and (4) above.

#### **(6) Additional record keeping requirement – IRO**

While we welcome the reduction in the proposed record keeping time limit requirements under the IRO following the Consultation (see Part 2, Clause 4, section 24(2)), we consider that these time limits still place ABS at a disadvantage when compared to conventional bonds. We appreciate that it may not be possible to have completely uniform record keeping requirements between ABS and conventional bonds, while also addressing avoidance concerns. However, we would encourage the Bills Committee to further reduce the period following the expiration of an ABS for which records

must be kept. We would also encourage the Bills Committee to align the record keeping periods of the IRO with the SDO to reduce the complexity of the rules and further ease the administrative burden on taxpayers.

***(8) Security requirements for stamp duty relief***

We note the increase in types of acceptable security that may be posted with the Stamp Duty Collector in order to satisfy the security posting requirements and obtain stamp duty relief (see Part 4, Clause 21, section 47F(3)). We note that even though the UK AFA Rules on which the Bill is based may require a legal charge in the favor of the tax authority as security, the legislation in other jurisdictions such as Singapore does not require security to be provided.

Therefore, we would encourage the Bills Committee to consider elimination of the requirement to post security, or in the absence of this, further liberalization of the manner in which security may be posted.

Should you wish us to clarify any of our comments above please do not hesitate to contact me.

Yours faithfully,

For and on behalf of  
Ernst & Young Tax Services Limited

A handwritten signature in black ink, appearing to be 'Florence Chan', written over a horizontal line.

Florence Chan  
Partner