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

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 ("the Bills Committee").

Background

Islamic finance and Islamic bonds

2. According to the Administration, Islamic finance¹ 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 bonds ("sukuk") are among the most prominent instruments used in Islamic finance, and have been commonly issued for raising funds in some domestic and international capital markets. As at the end of 2012, the amount of global outstanding sukuk topped US\$240 billion. Sukuk are investment certificates economically equivalent to bonds. Unlike conventional bonds, which are debt-based instruments that pay interest, sukuk are asset-based instruments and represent the ownership by the sukuk holders in the underlying pool of assets. Sukuk holders are entitled to an interest-like return in the form of a share in the revenues generated.

¹ Islamic finance refers to the financial activities that are consistent with the principles of Islamic law, known as Shariah. 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).

The Administration's initiatives to develop Islamic finance in Hong Kong

4. The policy initiative of developing Islamic finance in Hong Kong was first unveiled by the former Chief Executive in his 2007-2008 Policy Address and also enshrined in the Policy Addresses and the Financial Secretary ("FS")'s Budgets in the subsequent years. According to the Administration, the development of Islamic finance in Hong Kong will 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. The existing tax regime of Hong Kong is a major impediment to the development of a sukuk market. This is because sukuk have more complex product structures than their conventional bond counterparts. 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 when compared with conventional bonds. This has put sukuk in a disadvantaged position from the commercial viability point of view. The Administration therefore considers it necessary to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") and the Stamp Duty Ordinance (Cap. 117) ("SDO") to provide a comparable treatment for some common types of sukuk vis-à-vis conventional bonds in terms of profits tax, property tax and stamp duty liabilities.

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

6. The Administration introduced the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 ("the Bill") into the Legislative Council ("LegCo") on 9 January 2013. 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 does not confer special tax favours on the Islamic finance sector. It simply ensures that financial instruments of similar economic substance are afforded similar tax treatment. The Bill has adopted a religion-neutral approach in drafting. The term "alternative bond scheme" ("ABS"), instead of "sukuk", is used to denote the specified arrangements to which the proposed tax treatment shall apply.

7. The main provisions of the Bill are summarized below:

Amendment to IRO

- (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 as comprising a bond arrangement and an investment arrangement, and describing the relevant types of investment arrangements;
 - (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 FS 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.

Amendments to SDO

- (b) Clauses 21, 22 and 23 add new Parts VA, VB and Schedule 6 to SDO, which contain 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 with the latter 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) The new section 47L will also 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.

The Bills Committee

8. At the House Committee meeting on 11 January 2013, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is at **Appendix I**. Under the chairmanship of Hon CHAN Kam-lam, the Bills Committee has held seven meetings to discuss with the Administration and met with eight deputations for views in one of these meetings. The Bills Committee has also received 13 written submissions from deputations. The list of deputations from whom the Bills Committee has received views is at **Appendix II**.

Deliberations of the Bills Committee

9. The Bills Committee supports the Bill for its benefits in promoting the local bond market and developing Islamic finance in Hong Kong. The major deliberations of the Bills Committee are set out in the ensuing paragraphs.

Benefits of developing Islamic finance

10. The Bills Committee agrees with the Administration on the need to introduce the Bill to provide a comparable tax treatment for some common types of sukuk vis-à-vis conventional bonds in order to promote Hong Kong as a sukuk issuance platform which will serve as the first step in developing Islamic finance. Members note that the sukuk global market has seen rapid growth in recent years. Global new sukuk issuances witnessed a record high of US\$85 billion in 2011, and the first half of 2012 saw an impressive 40% year-on-year growth for global sukuk issuances. The Administration stresses that Hong Kong has a number of advantages in developing a sukuk market, including 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. Moreover, given Hong Kong's 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 who are interested in Islamic financial products. More importantly, development of Islamic finance in Hong Kong will help diversify the types of products and services available to Hong Kong's financial markets, and consolidate its status as an international financial centre and asset management centre.

11. The Bills Committee further notes the unanimous and overwhelming support from market players and practitioners for the Bill. Both the respondents to the Administration's consultation exercise on the proposed legislative amendments conducted in March 2012, and the deputations met by the Bills Committee welcome the Bill with a view to enhancing Hong Kong's competitiveness in financial services. In particular, they opine that the development may give impetus to increasing demands for Renminbi-denominated sukuk to match the financing needs of fund raisers and the investment demand of investors in China, the Middle East, South East Asia, and other parts of the world who are interested in Islamic financial products. The respondents and the deputations have also expressed the desire for the Bill to be passed as soon as possible so as to enable market players to use Hong Kong as a platform for issuance of sukuk, thereby maintaining the competitiveness of Hong Kong as a gateway for international Islamic finance.

Drafting approach of the Bill

12. The Bills Committee has enquired the rationale for adopting a religion-neutral approach in drafting the Bill. They are concerned that as key terms, such as "sukuk", and the names of common types of sukuk like "Ijarah" and "Musharakah" are not used in the Bill, Islamic bond issuers may not be aware of the new tax treatment for sukuk.

13. The Administration advises that the religion-neutral approach is modelled on the approach taken by the UK. The Bill also uses a prescriptive approach to describe key terms and essential features of sukuk without making specific references to Shariah terminologies. This approach is to ensure that the Bill will not unnecessarily import Shariah principles to the interpretation of Hong Kong tax laws under the legal system of Hong Kong. The Administration further explains that the Bill provides a clear legal framework for institutions structuring sukuk in the market in relation to their tax liabilities. It is noted that the religion-neutral approach was generally accepted by the market as shown in the responses to the public consultation exercise in 2012. There are no indication of any difficulties from market participants in understanding the application of the Bill. In this connection, the Bills Committee is aware that a number of submissions from the deputations have indicated agreement to the religion-neutral approach.

14. Noting that Malaysia, the UK, Singapore and Japan have amended their tax laws to facilitate the issuance of sukuk and the development of Islamic finance, the Bills Committee has enquired about the legislative amendments of these jurisdictions, including the approach taken and scope of tax treatment. The Administration explains that similar to Hong Kong, the legislative amendments in these jurisdictions aim 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. The coverage of tax treatment in each jurisdiction may vary. For instance, 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. The Administration further points out that as the taxation frameworks in different jurisdictions and legal systems vary to a considerable extent, a direct comparison may not be suitable.

Operation of an alternative bond scheme

15. The Bills Committee has examined issues relating to the structuring of sukuk and how the provisions in the Bill operate in providing a comparable tax treatment between conventional bonds and sukuk. The Bill provides that an ABS comprises a "bond arrangement" and an "investment arrangement". A specified ABS has to satisfy certain conditions ("qualifying conditions") in order to be treated as a "debt arrangement" and be eligible for the corresponding tax treatment under the Hong Kong tax laws. The details are explained in the following paragraphs.

Features of the alternative bond scheme and types of specified investment arrangements
(sections 2-11 of the proposed Schedule 17A to IRO, proposed section 47C of SDO)

16. In a typical sukuk structure, three parties are involved, namely an originator, a sukuk issuer, and sukuk holders. The originator is the party in need of funding and sets up a special purpose vehicle as sukuk issuer for the purpose of issuing sukuk certificates to obtain proceeds from sukuk holders. The sukuk issuer will then use the sukuk proceeds to acquire assets and arrange for management of the assets during the sukuk term with a view to generating income or gains to fund the coupon payments to sukuk holders. Upon maturity of the sukuk, the issuer will dispose of any remaining assets and make dissolution payment to sukuk holders to redeem the sukuk certificates.

17. In the context of the Bill, an ABS consists of a "bond arrangement" and an "investment arrangement". A bond arrangement is the arrangement between a bond-issuer (i.e. sukuk issuer) and bond-holders (i.e. sukuk holders), under which the bond-issuer issues alternative bonds (i.e. sukuk certificates) to bond-holders in return for bond proceeds (i.e. sukuk proceeds). An investment arrangement is the arrangement between the bond-issuer and an originator, under which the bond-issuer uses the bond proceeds to carry out some specified asset transactions or activities with a view to generating an investment return during the ABS term (i.e. sukuk term). The investment return, together with proceeds obtained from the disposal of the specified asset by the end of the ABS term under the investment arrangement, will be used to fund the coupon payments and redemption payments to bond-holders under the bond arrangement. The investment arrangement essentially represents the underlying structure of the ABS, and its specific features will be different depending on the types of arrangements in question.

18. The Bill specifies four types of investment arrangements (i.e. "specified investment arrangements") (section 5 of the proposed Schedule 17A to IRO) to correspond to the different underlying structures by which investment return is generated in five most common types of sukuk (sections 5 -11 of the proposed Schedule 17A to IRO) in the global market. These arrangements are –

- (a) lease arrangement ("Ijarah"): where a bond-issuer enters into a lease in respect of an acquired asset with an originator to generate an investment return;
- (b) profits sharing arrangement ("Musharakah" and "Mudarabah"): where a bond-issuer enters into a business undertaking with an originator to carry on business activities to generate an investment return;

- (c) purchase and sale arrangement ("Murabahah"): where a bond-issuer sells an acquired asset to an originator with a markup to generate an investment return; and
- (d) agency arrangement ("Wakalah"): where a bond-issuer appoints an originator as its agent to manage an acquired asset to generate an investment return.

The diagrams illustrating the features of an ABS and the underlying structures of the specified ABSs covered in the Bill are shown at **Appendix III**.

19. The Bills Committee notes that while the above mentioned five types of sukuk accounted for around 95% of global sukuk issuances in 2011 and the first half of 2012, some market practitioners considers that the tax laws should be flexible to accommodate other types of ABS as new sukuk types become popular, and to facilitate development in the market. The Administration explains that it has taken on board market comments received during the consultation in 2012 by adding "Wakalah" (agency arrangement) under the coverage of sukuk in the Bill as the product is becoming increasingly popular in the global sukuk market. Moreover, in response to market feedbacks, the Bill has included a provision (section 22 of the proposed Schedule 17A to IRO) to empower FS to expand the coverage of eligible ABS to respond to evolving market developments in future, by way of subsidiary legislation which are subject to the negative vetting procedure of LegCo. The Bills Committee supports the Administration's initiative in this respect.

*Qualifying conditions for specified alternative bond schemes
(sections 13 -19 of the proposed Schedule 17A to IRO)*

20. In relation to a specified ABS under the Bill, the following five conditions must be satisfied before a bond arrangement in the specified ABS is qualified to be treated as a "debt arrangement" for the purposes of IRO and SDO –

- (a) "reasonable commercial return" condition: Both the maximum total amount of the bond return² 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;

² In the context of the Bill, bond return means coupon payments and discount/premium in the case of coupon-paying bonds, and discount / premium in the case of zero-coupon bonds.

- (b) "bond arrangement as financial liability" condition: The bond arrangement in a specified ABS must be treated as a financial liability of the bond-issuer in accordance with either the Hong Kong Financial Reporting Standards or International Financial Reporting Standards;
- (c) "Hong Kong connection" condition: The alternative bonds must be listed on a stock exchange in Hong Kong, or issued in good faith 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;
- (d) "maximum term length" condition: The term of the specified ABS must not be longer than 15 years; and
- (e) "arrangements performed according to terms" condition: The specified ABS must be performed according to the features and characteristics as prescribed in the Bill.

21. In addition, the following two conditions must be complied with in order for an investment arrangement in the specified ABS to be treated as a "debt arrangement" under tax laws –

- (a) "bond-issuer as conduit" condition: Under the terms of the specified ABS, 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
- (b) "investment arrangement as financial liability" condition: The investment arrangement in the specified ABS must be treated as a financial liability of the originator in accordance with either the Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

22. On members' enquiry about the reasons for imposing qualifying conditions on a bond arrangement and an investment arrangement, the Administration explains that they are to ensure that 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; to put in place reasonable safeguards to minimise tax avoidance; and to ensure the proposed taxation framework would encourage the sukuk benefitted from the framework to have a nexus with Hong Kong, hence directly promoting Hong Kong's financial market development.

23. In respect of the qualifying conditions for a bond arrangement, members note that some deputations have expressed concern about the operation of the "reasonable commercial return" condition. Specifically, there are concerns about the condition limiting bond-holders from benefitting better returns on a sukuk, why the returns generated in the whole sukuk term and each payment period should be considered, and why no adjustment is allowed to take account of the rate of inflation.

24. The Administration explains that it is the general principle under IRO to treat an arrangement as a debt arrangement if it is a debt arrangement in both form and substance. To facilitate the development of a sukuk market in Hong Kong, the Bill allows an arrangement to be treated as a debt arrangement as long as it is such an arrangement in substance. In line with this basic premise of the Bill, the "reasonable commercial return" condition requires an arrangement to yield no more than reasonable commercial return compared to a loan of money. Without an arrangement meeting the "reasonable commercial return" condition, the basic premise for treating it as a debt arrangement is not established. The Islamic concept of "sukuk" covers a variety of instruments. In terms of returns to investors, some sukuk are debt-like, some linked to equity profits. The Bill aims to apply to debt-like sukuk tax treatment comparable to that applicable to conventional debt arrangements, due to their equivalence in terms of economic substance. The Commissioner of Inland Revenue ("CIR") therefore needs to have regard to the quantum of the return to investors, in relation to each payment period and the whole term of the instrument, in order for him to be satisfied that the bond return of an alternative bond scheme will not exceed an amount that would be a reasonable commercial return on money borrowed of an amount equal to the bond proceeds.

25. As regards concern about the impact of the "reasonable commercial return" condition on sukuk holders, the Administration clarifies that the condition does not seek to disallow bond-holders to benefit from better investment returns or 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. It only impacts on whether the "sukuk" may be treated as if it were a debt arrangement. The fact that a sukuk does not comply with the condition only means that the sukuk cannot be regarded as a debt arrangement for tax purposes. The test should not have any impact on the attractiveness of sukuk if they are equivalent to conventional debt arrangements in terms of economic substance, and will not disqualify a sukuk arrangement merely because it is paying floating coupon payments.

26. To offer the market more clarity in the consideration of the "reasonable commercial return" condition, the Bills Committee welcomes CIR's initiative to elaborate the operation of the condition in a Departmental Interpretation and

Practice Note ("DIPN"). The Administration explains that the test will exclude sukuk where (a) the fixed rate or margin is blatantly above what would be reasonable for a commercial debt security on similar terms and carrying similar risks; or (b) the proposed or actual periodic distributions are linked to profits, as these kinds of patterns of returns suggest that the instrument in question is an equity sukuk. The prevailing market conditions (including interest rate and inflation), the credit rating of the issuer concerned, and the terms of the product will all be considered. Sukuk issuers may also seek an advance ruling under section 88A of IRO if in doubt.

27. The Bills Committee has sought the Administration's views on some deputations' suggestion of removing the "maximum term length" condition in order to cater for market development. The Administration responds that the maximum length condition was originally set at ten years in the 2012 consultation paper and has been relaxed to no longer than 15 years in the Bill having regard to market views. As 90% of global sukuk issuances in the past decade were of a term of 15 years or less (in fact over half of such issuances were of a short term of five years or less), the Administration considers that the proposed maximum period has struck a reasonable balance between facilitating market development and addressing tax avoidance concerns. The Administration further advises that to meet future demand and evolving market needs, the Bill has included a provision (section 16(2) of the proposed Schedule 17A to IRO) to enable FS to amend the term length limit in future by way of subsidiary legislation which is subject to negative vetting by LegCo.

28. On the "Hong Kong connection" condition, some members are concerned that one of the four alternatives to satisfy the condition – alternative bonds "are marketed in Hong Kong" (section 15(c) of new Schedule 17A), may not ensure the arrangement in question has a Hong Kong connection since a sukuk issuer may arrange the sale of sukuk in an overseas market but only launch marketing activities in Hong Kong for the sukuk. The Administration reiterates that the "Hong Kong connection" condition is intended to encourage alternative bonds that seek to benefit from the proposed tax treatment or relief to have a nexus with Hong Kong, thus directly promoting its financial market development. In complying with the condition, the relevant issuers should demonstrate genuine actions or activities to market sukuk in Hong Kong (i.e. by way of conducting promotional activities such as advertising and making an offer for sale such as issuing or distributing offering documents). CIR will look at the facts and circumstances of each case in considering the compliance with the condition. Promotional activities alone may not be sufficient to satisfy this condition. The Administration further points out that the term "marketed" in the English text of the Bill carries the meaning of "to advertise, promote and offer for sale". In the Chinese text, the term "銷售" is used to convey the same meaning. Hence, the relevant provision, as currently drafted, is able to reflect the intent suitably. If necessary, CIR will give suitable clarification of the operation through a DIPN.

*Tax treatment of qualified specified alternative bond schemes
(sections 20-21 of the proposed new Schedule 17A to IRO, proposed section
47E, 47F and 47G of SDO)*

29. The Bill Committee notes that the Bill provides for certainty of the tax position of qualified bond arrangement and qualified investment arrangement under a specified ABS. The underlying principle is to treat those arrangements in a specified ABS that meet the qualifying conditions as "debt arrangements" for the purposes of IRO and SDO, and to apply comparable tax treatments accordingly, by making necessary modifications to the relevant provisions of IRO and SDO. Diagrams showing the tax treatments on a qualified bond arrangement and a qualified investment arrangement are at **Appendix IV**. The details are elaborated in the following paragraphs.

30. As regards a qualified bond arrangement, the Bill provides 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. In line with this, the Bill modifies specific provisions of IRO and SDO for the following purposes –

- (a) the tax concession and exemption for qualifying debt instruments under sections 14A and 26A of the IRO will apply to alternative bonds transferrable by their delivery issued under a qualified bond arrangement;
- (b) coupon payments payable to bond-holders on the alternative bonds issued under a qualified bond arrangement will be accorded the same treatment, for deductions, under section 16(2)(f) of the IRO that applies to interest payable on conventional bonds;
- (c) the tax exemption under section 20AC of IRO for certain profits of non-residents applicable to transactions in conventional bonds will be extended to apply to transactions in alternative bonds issued under a qualified bond arrangement;
- (d) a qualified bond arrangement is not to be regarded as a mutual fund, unit trust or similar investment schemes for the purposes of section 26A of IRO;

- (e) section 15(1)(j), (k) and (l) of the IRO (which treats any disposal gains before maturity and the premium/discount element received on maturity of certificates of deposits as trading receipts for profits tax purposes) will be extended to alternative bonds under a qualified bond arrangement that are transferrable by their delivery; and
- (f) transfer of an alternative bond issued under a qualified bond arrangement will not be subject to stamp duty charges on Hong Kong stocks in most cases under SDO.

31. As regards a qualified investment arrangement between an originator and a bond-issuer (in relation to the underlying assets of a specified 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. In line with this, provisions are made in IRO and SDO for the following purposes –

- (a) certain asset transactions³ (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 under IRO. 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. Similarly, instruments executed to effect, or as an agreement for, these transactions will be exempted from stamp duty under SDO, on security being given to reduce the risk of irrecoverable duty in the event of any subsequent withdrawal of stamp duty relief; 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 under section 5B of IRO for the purposes of property tax.

32. The Bills Committee notes that the purpose of proposed sections 47F and 47G of SDO is to provide stamp duty and special stamp duty ("SSD") relief for an instrument in relation to transactions in Hong Kong properties held under

³ 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 has included a provision (section 22 of the proposed Schedule 17A to IRO) to empower FS to specify relevant transactions to be likewise disregarded by way of subsidiary legislation (subject to negative vetting by LegCo) to provide tax relief for eligible ABS and cater for market developments.

a qualified investment arrangement in a specified ABS. Noting that the Administration has introduced the enhanced SSD, new buyer's stamp duty, and the enhanced ad valorem stamp duty under the Stamp Duty (Amendment) Bill 2012 and the Stamp Duty (Amendment) Bill 2013 which are under scrutiny by two relevant Bills Committees in LegCo, some members have enquired about the tax treatment for qualified investment arrangements in respect of the above three new stamp duties if the two relevant bills are passed by LegCo. The Administration advises that its intention is to grant relief from the three new stamp duties for instruments relating to transactions in Hong Kong properties held under a qualified investment arrangement in a specified ABS. Hence, subject to the discussions of the relevant Bills Committees, the Administration will consider introducing consequential amendments to the relevant legislation as appropriate to give effect to the relief for the three new stamp duties. Members also note that the Administration is prepared to consider applications for remissions or refunds of the new stamp duties under section 52 of SDO as and when necessary.

Tax administration matters

(sections 23-28 of the proposed Schedule 17A to IRO, proposed section 47H-47L of SDO)

33. The Bill provides for record-keeping, notifications, assessments and other miscellaneous matters to address tax avoidance concerns. There are provisions to modify the existing section 51C of IRO, and add new provisions to SDO, to require persons granted tax or stamp duty relief in respect of a specified ABS to keep records for a reasonable period. They will be obliged to inform CIR and the Collector of Stamp Revenue ("CSR") of any disqualifying event, which may lead to a withdrawal of the relief granted in its entirety under IRO and SDO.

Disqualification of qualified bond arrangement or qualified investment arrangement

(sections 12(3), (4) and 23 of the proposed Schedule 17 A to IRO, proposed section 47D, 47H of SDO)

34. The Bills Committee notes that if any of the qualifying conditions for a bond arrangement or an investment arrangement is not complied with, the arrangements previously qualified as a bond arrangement or an investment arrangement will become disqualified. The special tax treatment granted to the bond arrangement under IRO will be withdrawn retrospectively, and that given under SDO will cease to apply. As for the disqualified investment arrangement, the special tax treatment under IRO will be withdrawn retrospectively, and the concerned party will have to pay the stamp duty chargeable. Members note that to avoid tax evasion, section 25 of the proposed Schedule 17A to IRO and proposed section 47H of SDO require a claimant to notify CIR/CSR within 30 days after the occurrence of a bond

arrangement/investment arrangement disqualifying event. Failure to do so will be an offence in the case of IRO, and will entail a civil penalty on the claimant in the case of SDO.

35. Members are aware that some deputations have raised concern about the serious consequences of the disqualification to a qualified bond arrangement or a qualified investment arrangement, and have suggested that IRD should take into account "unavoidable commercial circumstances" before determining the disqualification for a scheme. Some members further consider that a bond-issuer should be allowed under certain circumstances, such as administrative oversight, to make rectification for the disqualification event within a time limit so as to prevent the withdrawal of the special tax treatment and stamp duty relief.

36. The Administration points out that it would be difficult to determine what "unavoidable commercial circumstances" will render it suddenly impossible for a scheme to comply with the qualifying conditions prescribed in the Bill. The Administration is concerned about a possibility under which an ABS may be deliberately structured to meet the qualifying conditions in the earlier part of the term to take the tax relief, while distributing coupon payments that is blatantly above reasonable commercial return or linked to profits in the later part of the term. In this case, the arrangement concerned will essentially be an "equity-like" sukuk arrangement, which is not economically equivalent to debt arrangements. As the Bill seeks to treat debt-like sukuk arrangements as debt arrangements, the disqualification rules are reasonable on anti-avoidance grounds. As regards reporting of the disqualifying events, the Administration points out that while the originator or bond-issuer was required to report to CIR/CSR in writing of the occurrence of any disqualifying event within 30 days after the event, section 17(2) of the proposed Schedule 17A to IRO provides a 30-day grace period for delay in disposing of the specified asset to deal with market concern. In addition, section 27 of the proposed Schedule 17A to IRO and proposed section 47H(7) of SDO empower CIR/CSR to disregard the longer delay in asset disposal as a breach of the concerned arrangements if there is a reasonable excuse for the delay.

Record keeping requirements

(section 24 of the proposed Schedule 17A to IRO, proposed section 47J of SDO)

37. As regards the record-keeping requirements, the Administration explains that for the purposes of IRO, the Bill seeks to require 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. As for SDO, the Bill requires relevant documents to be kept until the expiry of one year after the end of the ABS term. Members note that while the Administration has shortened the record-keeping period in response to market suggestions made in the 2012 consultation, some deputations consider that the

period should be further relaxed so that a sukuk issuance would not be disadvantaged vis-à-vis that for conventional bonds. The Administration stresses that a proper balance should be struck between facilitating compliance by bond-issuers and ensuring the power of CIR/CSR to pursue necessary assessment work and tackle tax avoidance. For the purpose of IRO, the requirement for keeping relevant documents has been relaxed to "three years (instead of seven years) after the end of the sukuk term" or "seven years after the relevant transaction", whichever is longer. For the purpose of SDO, the requirement has been relaxed to "one year (instead of seven years) after the end of the sukuk term". Members also note that due to the unique structures of sukuk, it is the market practice to keep the relevant transaction documents at least during the entire term of the sukuk. The Administration considers the proposed record-keeping period reasonable and should represent minimum compliance efforts on the part of an issuer in order for it to be eligible for the proposed tax relief or treatment. The streamlined record-keeping requirements will enable CIR/CSR to assess whether certain qualifying conditions (for example, "reasonable commercial return" and "bond-issuer as conduit" conditions) are met and to re-assess the arrangements upon withdrawal of the special tax treatment or relief. To cater for development in information technology and to facilitate bond-issuers, the Administration will accept business records kept in electronic form.

*Additional profits tax assessment and recovery of stamp duty
(section 26 of the proposed Schedule 17A to IRO, proposed section 4(5A) of SDO)*

38. Existing section 60 of IRO empowers IRD to raise any assessment or additional assessment within six years after the expiration of the relevant year of assessment. Existing section 4(5) of SDO provides that CSR shall not recover stamp duty with respect to any instrument more than six years from the expiration of the time for stamping such instrument. The Bills Committee notes that section 26 of the proposed Schedule 17A to IRO modifies sections 60 and 79 of IRO so that the relevant time limits will run after the expiration of the year of disqualification if that year falls after the relevant year of assessment. A new section 4(5A) is also added in SDO to provide for the same extension in the current limitation period of six years for the recovery of stamp duty after the disqualifying event. Members have sought the Administration's response on some deputations' concern about the need to extend the two time limits on grounds that this may put sukuk at a less favourable position than conventional bonds. The Administration explains that the proposed extension of time frames is needed to plug the tax avoidance loophole arising from breaching of the qualifying conditions near the end of the specified term of an ABS. This is particularly relevant to a longer-term sukuk involving a disqualifying event. Moreover, without the extended limitation period in the proposed section 4(5A), there will be an obvious loophole for stamp duty avoidance, especially when a bond-issuer and an originator will likely to be related parties for asset transfers.

The Administration stresses that the extended limitation periods do not only seek to enable CIR to make an additional assessment or CSR to recover the stamp duty chargeable, they apply also to refunding tax paid in excess to taxpayers. Where the sukuk transactions are determined to be ineligible for the proposed special tax treatment, there will be cases where coupon payments taxed previously in a profits tax assessment as "interest income" are treated as non-taxable distributions, and tax paid in excess can then be refunded to sukuk holders.

Security arrangement for stamp duty relief

39. The Bills Committee notes that as a measure to reduce the risk of irrecoverable duty in the event of any withdrawal of stamp duty relief from originators or bond-issuers, the Bill has included the payment of a security under the proposed section 47F(3) of SDO. Some members and deputations have suggested relaxing or removing the security requirement to avoid imposing additional cost and administrative burden for the sukuk arrangement. The Administration explains that the security requirement is necessary to protect the revenue in case a previously granted stamp duty relief to an originator or a bond-issuer is withdrawn due to any disqualification. In order to provide flexibility to originators or bond-issuers in complying with the requirement and to minimise their costs, CSR is prepared to accept a security which may include a registered first legal charge on the leasehold property, a pledge of quoted shares or a bank guarantee. Taking on board market concern, CSR is prepared to elaborate the operational details of the security arrangement in a Stamp Office Interpretation and Practice Note ("SOIPN").

Interpretation and Practice Notes for explaining operational details of ABS

40. The Administration points out that with a view to facilitating implementation of the Bill after its enactment, and addressing views expressed during the consultation exercise, CIR/CSR will be prepared to issue DIPN and SOIPN to explain tax matters concerning sukuk. DIPN and SOIPN will cover issues and clarify detailed operational matters in connection with, for example, withdrawal of special tax treatment or stamp duty relief due to a breach of qualifying condition (section 12 of the proposed Schedule 17A to IRO), the reasonable commercial return condition (section 13 of the proposed Schedule 17A to IRO), additional assessments and tax refunds (section 26 of the proposed Schedule 17A to IRO), as well as the proposed security arrangement for stamp duty determination and charge under SDO (proposed section 47F(3) of SDO). The Bills Committee welcomes the Administration's initiative in this respect. Members further share with the deputations' views that IRD should retain professional expertise in the Department to deal with Islamic finance transactions, and incorporate professional bodies and Shariah experts in developing the relevant practice notes and guidelines as appropriate.

Infrastructures to support the development of Islamic finance in Hong Kong

Training of professionals and market practitioners

41. The Bills Committee considers it important for Hong Kong to nurture adequate professionals with knowledge of Shariah in Hong Kong to support the development of Islamic finance and handle sukuk-related disputes. Members further note that many deputations have stressed the need for the Administration to step up efforts in engaging professionals and training for market practitioners. The Bills Committee has urged the Administration to promote exchange and co-operation with other financial centres in the development of Islamic finance and diversification of Islamic finance instruments besides sukuk.

42. The Administration stresses that it fully appreciates the importance in nurturing professionals and market practitioners with expertise in Islamic finance, as well as maintaining continuous dialogue with relevant parties in major Islamic financial markets in order to better understand the latest global developments. The Administration assures members that it has been working in this direction on various fronts. For example, the Hong Kong Monetary Authority ("HKMA") has 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. Over the past few years, 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, including organising 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, which have received positive response from the market. Moreover, in September 2012, representatives of the Financial Services and the Treasury Bureau and 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. The Administration considers that these ongoing interactions will be useful in building interest in Islamic finance activities in Hong Kong, and assures members that it will continue to work with the market and interested parties to this end.

Investor protection and legal issues

43. Given that sukuk are innovative financing instruments and have more complex structures than conventional bonds as well as involving different underlying assets and relationships among the originator, bond-issuer and bond-holders, the Bills Committee has expressed concerns about protection for

sukuk investors, including regulation over sukuk issuers, investor education on risks involved in investment of sukuk, and applicable law (i.e. Hong Kong laws or Shariah law) for dealing with legal disputes relating to sukuk.

44. On the investor protection front, the Administration explains that similar to other financial products, sukuk will be subject to the prevailing regulatory regime in respect of product offering, marketing, disclosure and intermediaries requirements in accordance with the relevant provisions of the Securities and Futures Ordinance (Cap. 571) ("SFO") and the Companies Ordinance (Cap. 32) ("CO"). As such, issuers are required under SFO to seek authorization from the Securities and Futures Commission 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 are in the form of shares or debentures, CO 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 in place so that product issuers are required to make adequate disclosure and thus afford a measure of protection to investors. 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 will work with the regulators on enhancing investor education on sukuk and Islamic finance.

45. As regards the law governing sukuk-related disputes and the handling of such disputes, the Administration reiterates that the Bill adopts a religion-neutral approach in drafting. As far as sukuk issuances are concerned, a sukuk issuer will ensure that the sukuk are structured in Shariah-compliant ways. The offering documents of the sukuk will specify 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). It is also observed that in many contractual disputes involving cross-border Islamic financial transactions, the parties concerned have identified English court and English law as the relevant choices. The Bill concerns the tax treatment of sukuk under the Hong Kong tax laws and does not seek to change the law governing the sukuk. In this connection, the Bills Committee understands from deputations that replacement of underlying assets will be arranged if a sukuk has been declared non-compliant with Shariah. The details pertaining to replacement of underlying assets will be given in the relevant transaction documents. The market has not encountered difficulties in resolving legal disputes relating to sukuk.

Committee Stage amendments proposed by the Administration

46. The Bills Committee has examined and supported the Committee Stage amendments ("CSAs") proposed by the Administration which are mainly technical and textual in nature, and made to better clarify the intent of some provisions, improve and maintain consistency in drafting, as well as provide cross references to facilitate readers. The major CSAs are highlighted as follows:

- (a) Clause 4 – (i) adding a new definition of "special purpose vehicle" in section 1 of the proposed Schedule 17A to IRO to make clear the intent for the "bond-issuer" in an ABS to be a "special purpose vehicle"⁴; and (ii) splitting section 10 of the proposed Schedule 17A into a revised section 10 and a new section 11A to simplify the drafting and provide a clearer understanding on the calculation of investment return under different types of investment arrangements.
- (b) Clause 6 – amending paragraph (g) in the definition of "debt investment" in section 14A of IRO to state clearly that: (i) a qualifying debt instrument issued on or after 24 May 1996 but before 14 November 2003 may be treated as a *debt instrument* within the meaning of section 14A of IRO to the extent that it would have been if paragraph (g) of the relevant definition as amended had always been in force; and (ii) any previous assessment made on the above basis is declared to be valid to the extent that it would have been if paragraph (g) of the relevant definition as amended had always been in force; and
- (c) Clause 21 – amending the proposed section 47G of SDO to provide for the same security arrangement (as in the proposed section 47F(3) of SDO) for relief from special stamp duty.

Resumption of Second Reading debate

47. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 10 July 2013.

⁴ The definition will provide flexibility in the business form of the special purpose vehicle to cover a corporate entity or a partnership.

Committee Stage amendments

48. The Bills Committee has not proposed CSAs to the Bill and supports the CSAs proposed by the Administration.

Consultation with the House Committee

49. The Bills Committee reported its deliberations to the House Committee on 21 June 2013.

Council Business Division 1
Legislative Council Secretariat
3 July 2013

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

Membership list

Chairman Hon CHAN Kam-lam, SBS, JP

Members Hon Abraham SHEK Lai-him, GBS, JP
Hon Ronny TONG Ka-wah, SC
Hon Starry LEE Wai-king, JP
Hon Kenneth LEUNG
Hon Christopher CHEUNG Wah-fung, JP
Hon SIN Chung-kai, SBS, JP

(Total : 7 members)

Clerk Ms Connie SZETO

Legal Adviser Mr KAU Kin-wah

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

List of organizations from whom the Bills Committee has received views

1. BOCHK Asset Management Limited
2. Citibank N.A. Hong Kong Branch
3. The DTC Association
4. Ernst & Young Tax Services Limited
5. The Hong Kong Association of Banks
6. Hong Kong Bar Association
7. Hong Kong Investment Funds Association
8. Kowloon Mosque
9. Labuan IBFC Incorporated SDN BHD
10. The Law Society of Hong Kong
11. Nasirs
12. Nova Training and Education Institute Limited
13. PricewaterhouseCoopers Limited
14. Standard Chartered Bank
15. The Taxation Institute of Hong Kong
16. Treasury Markets Association

Features of the Alternative Bond Scheme

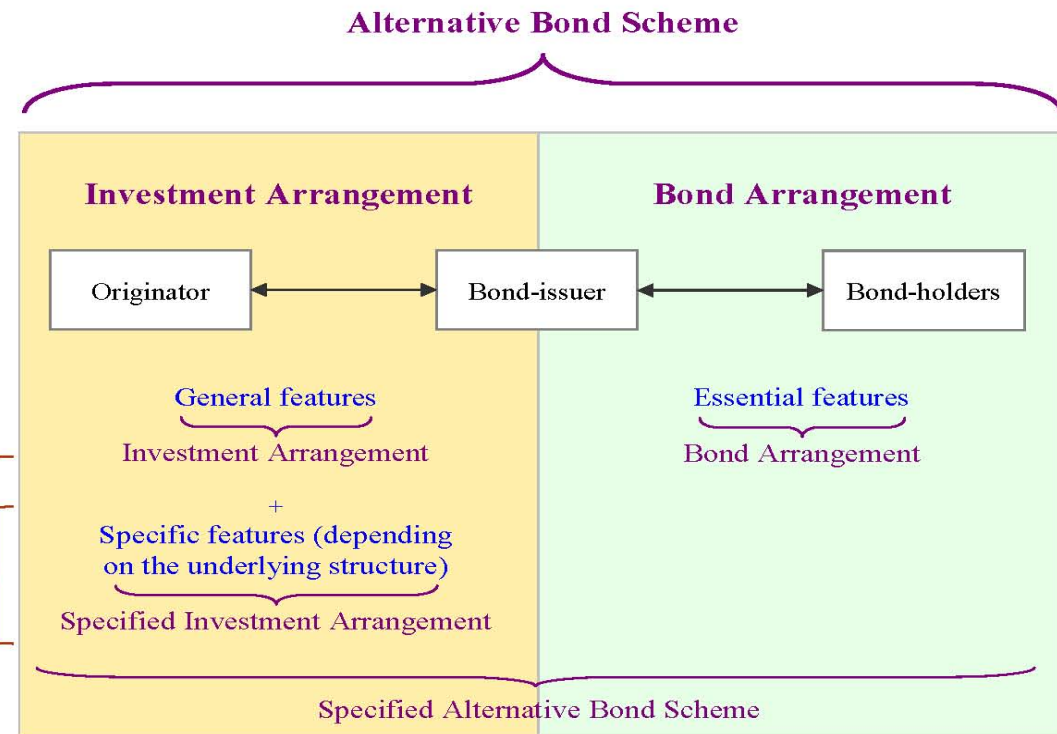
IRO: Schedule 17A, Sections 2-4
SDO: Section 47C

- Alternative Bond Scheme (ABS) = Bond Arrangement (BA) + Investment Arrangement (IA)
- Features of BA and IA

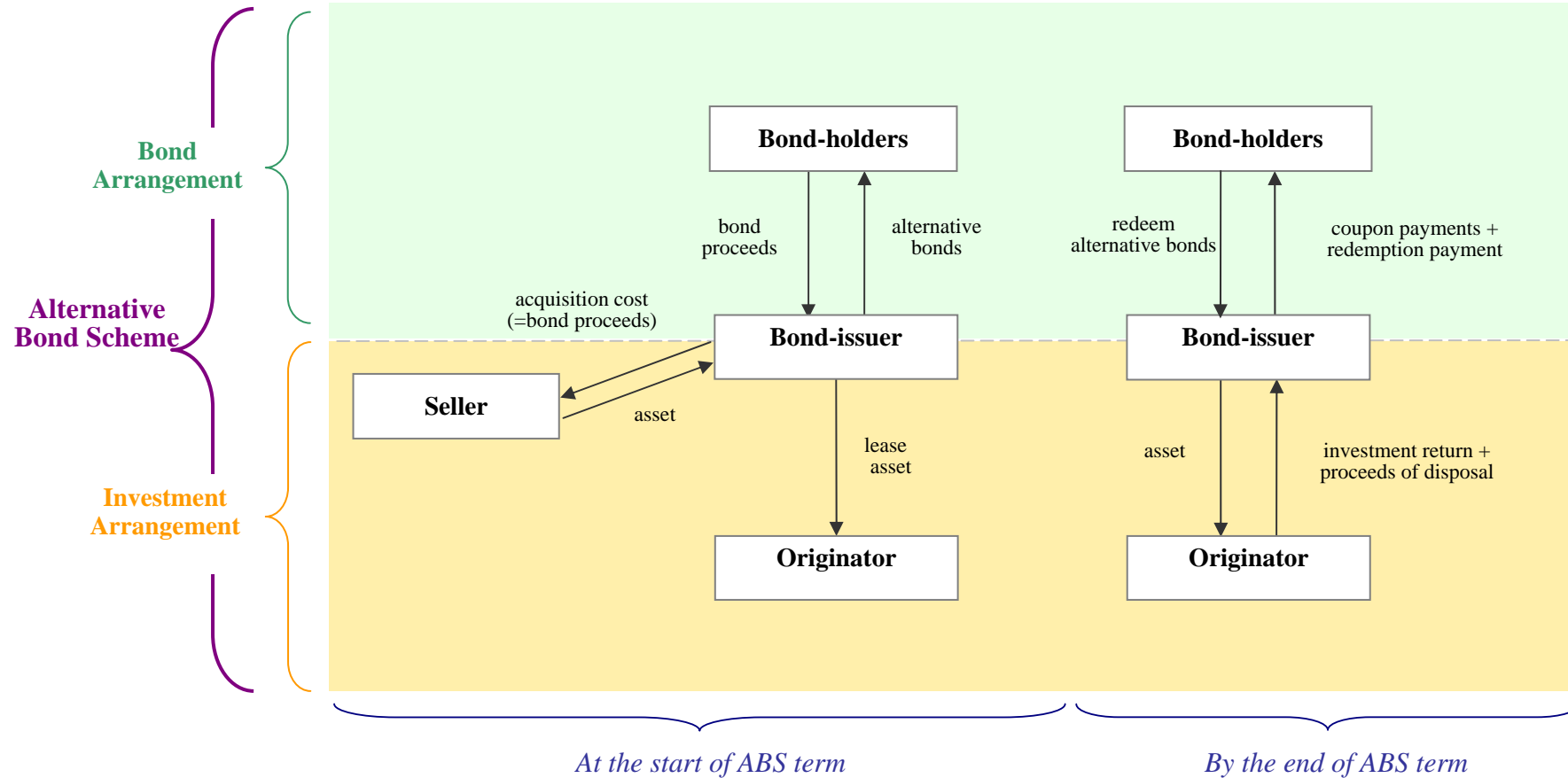
IRO: Schedule 17A, Sections 5-11
SDO: Section 47C

Types of specified investment arrangements

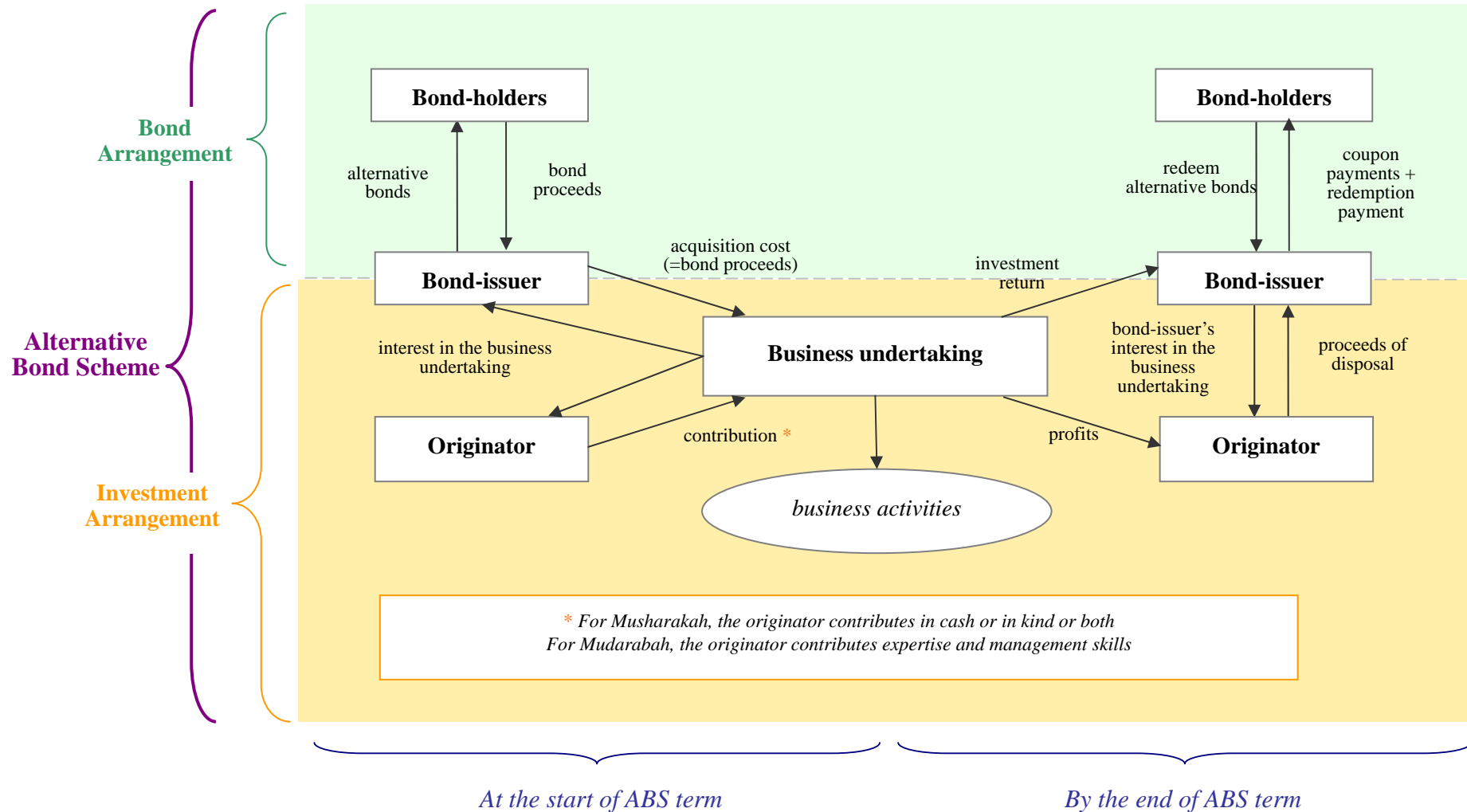
- Lease (Ijarah)
- Purchase and Sale (Murabahah)
- Profits Sharing (Musharakah and Mudarabah)
- Agency (Wakalah)



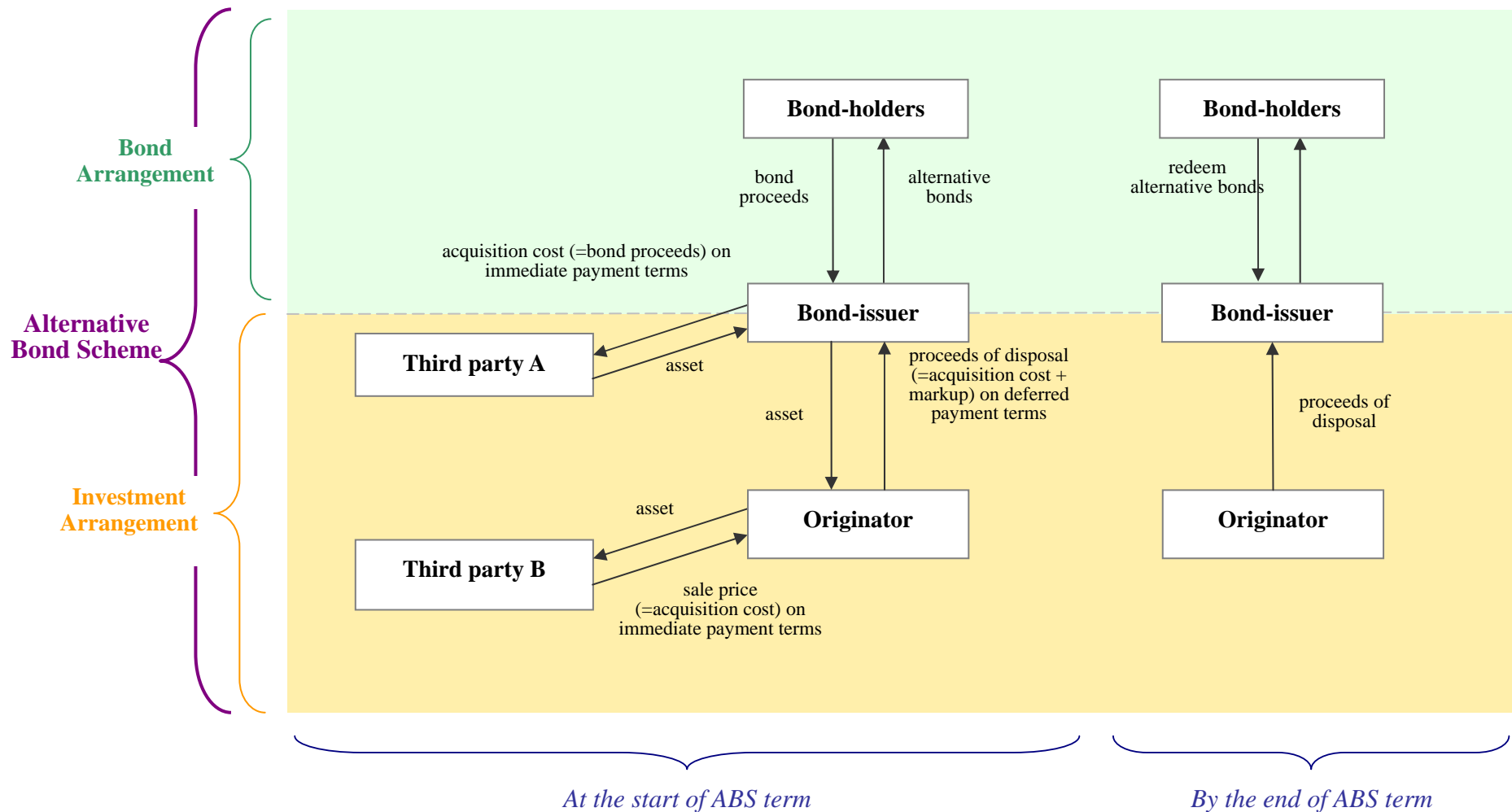
1. Diagram illustrating the key features of ABS structured on the basis of lease arrangement ("Ijarah")



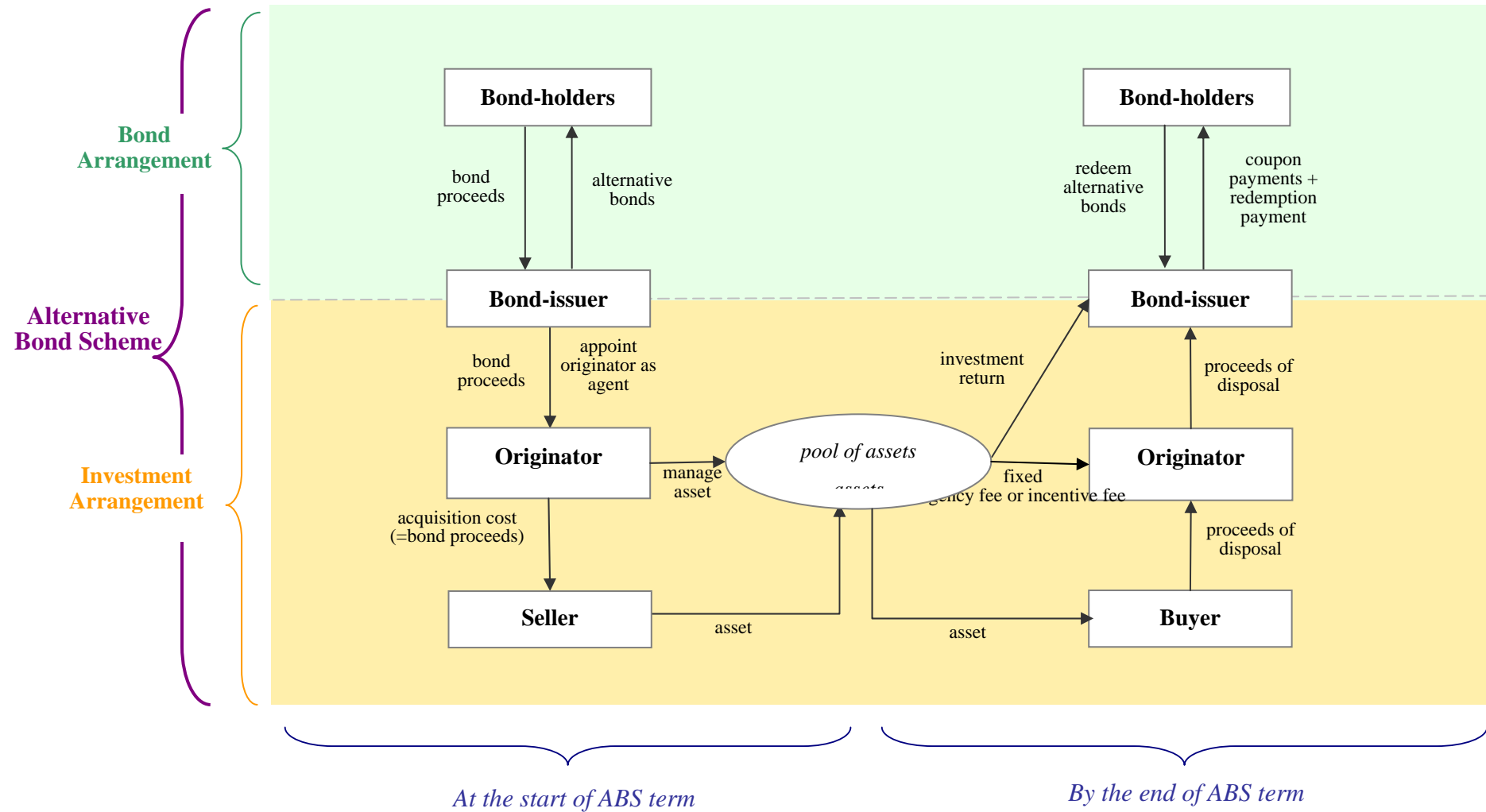
2. Diagram illustrating the key features of ABS structured on the basis of profits sharing arrangement ("Musharakah" and "Mudarabah")



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")

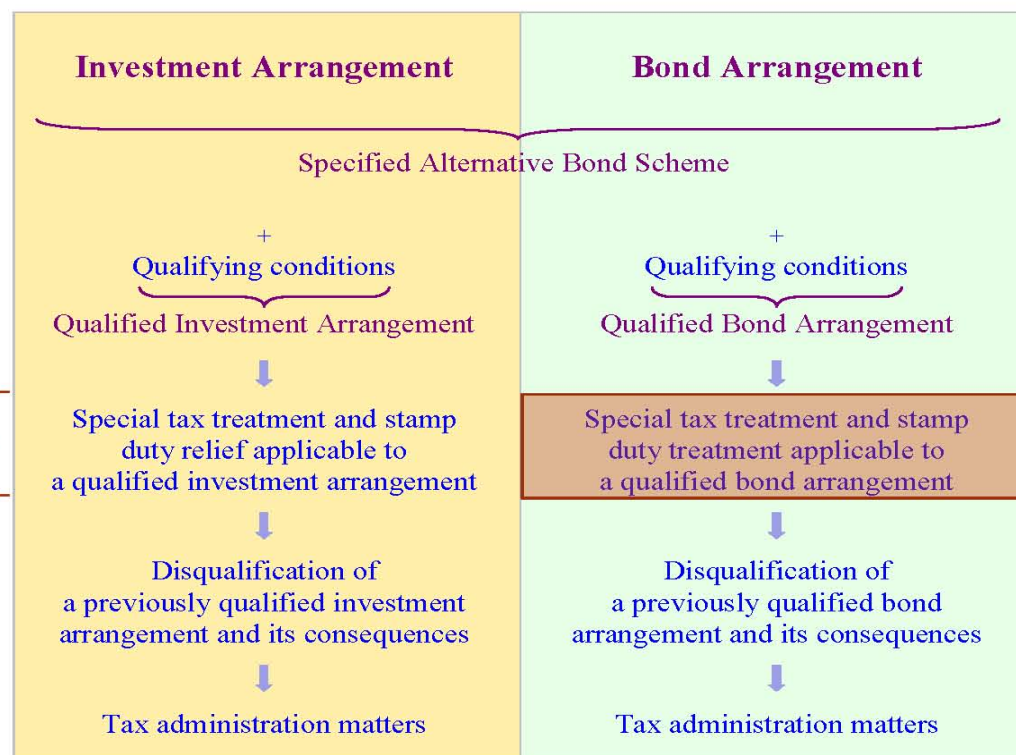


Tax treatments

IRO: Schedule 17A, Section 20
SDO: Section 47E

Qualified BA

- Qualified BA regarded as a debt arrangement (IRO)
- Bond proceeds regarded as money borrowed by bond-issuer from bond-holders (IRO)
- Coupon payments regarded as interest payable on money borrowed (deductible) (IRO)
- Tax concession and exemption for qualifying debt instruments (IRO)
- Tax exemption for certain profits on non-residents applicable to bond transactions (IRO)
- Exemption of stamp duty for certain bond transfer (SDO)



Tax treatments

IRO: Schedule 17A, Section 21

SDO: Sections 47F&47G

Qualified IA

- Qualified IA regarded as a debt arrangement (IRO)
- Certain asset transactions among bond-issuer, originator and their business undertaking disregarded for profits tax purposes (IRO)
- Stamp duty not chargeable on instruments relating to certain asset transactions; transactions disregarded in the specified period for determining special stamp duty liability (SDO)
- Related rental transactions disregarded for property tax purposes (IRO)

