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Legal Service Division Report on Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012

I. SUMMARY

1. **The Bill**
   (a) The Inland Revenue Ordinance (Cap. 112) is amended to accord specified arrangements with tax treatment as debt arrangements, and the Stamp Duty Ordinance (Cap. 117) is amended to provide stamp duty relief for certain transactions under such specified arrangements and to provide for incidental and consequential matters.
   (b) The Bill adopted a religion neutral approach by prescribing the conditions that an arrangement must comply with before it may be accorded with the tax treatment of a debt arrangement and the relevant stamp duty relief.
   (c) The amendments to Cap. 112 only apply to specified types of arrangements that in the context of Islamic finance are known as *sukuk*[1] which are economically equivalent to issuing bonds.

2. **Public Consultation** According to the Administration, a large majority of the respondents to the public consultation conducted in March 2012 welcomed the legislative objectives and proposal.

3. **Consultation with LegCo Panel** The Panel on Financial Affairs was consulted on 5 November 2012. Various concerns were expressed by Panel members.

4. **Conclusion** Since the legislative proposal is conceived as the first step in developing Islamic finance in Hong Kong, Members may wish to set up a Bills Committee to study the policies and the Bill in detail.

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1 *Sukuk* are tradable, asset-backed, medium-term notes. The name *sukuk* is sometimes translated as certificates, or less accurately, as Islamic bonds. (See Visser, Islamic Finance Principles and Practice, 63).

II. REPORT

The date of First Reading of the Bill is 9 January 2013. Members may refer to the LegCo Brief (File Ref.: B9/33/2C) issued by the Financial Services and the Treasury Bureau on 24 December 2012 for further information.

Object of the Bill

2. The Inland Revenue Ordinance (Cap. 112) is amended to accord specified arrangements with tax treatment as debt arrangements, and the Stamp Duty Ordinance (Cap. 117) is amended to provide stamp duty relief for certain transactions under such specified arrangements and to provide for incidental and consequential matters.

Background

3. The Islamic law, the s*haria* (or *shariah*), prohibits payment for the use of money. Issuance of conventional bonds as practised in non-Islamic jurisdictions is not consistent with Islamic law. Alternative financial arrangements have been developed to accommodate the precepts of the *sharia*. One of the more common arrangements is the *sukuk*. As assets-backed notes, *sukuk* may be backed by a lease arrangement (*Ijarah*), a profit sharing arrangement (*Musharakah* or *Mudarabah*), or a purchase and sale arrangement (*Murabahah*) or an agency arrangement (*Wakalah*).

Provisions of the Bill

4. The Bill adopted a religion neutral approach by stipulating the conditions that an arrangement must satisfy before it is accorded the tax treatment of a debt arrangement. This means that even if an arrangement may not be *sharia* compliant, so long as all the statutory conditions are satisfied, the arrangement would be regarded as a debt arrangement for Cap. 112. Some transactions underlying the arrangement would also enjoy relief from the stamp duty under Cap. 117.

Major Amendments to Cap.112

5. The Bill introduces the expression of "alternative bond scheme" which has two component arrangements known as the "bond arrangement" (BA) and the "investment arrangement" (IA) (clause 4: section 2 of Schedule 17A). The provisions reflect the structure of *sukuk*.

6. A specified alternative bond scheme (specified scheme) may only be recognized as such when it is an alternative bond scheme and its IA is a specified IA at all material time (clause 4: section 4 of Schedule 17A).

7. Four types of IA are specified (clause 4: section 5 of Schedule 17A):-

(a) a lease arrangement (clause 4: section 6 of Schedule 17A);

(b) a profit sharing arrangement (clause 4: section 7 of Schedule 17A);

(c) a purchase and sale arrangement (clause 4: section 8 of Schedule 17A); and

(d) an agency arrangement (clause 4: section 9 of Schedule 17A).

They respectively mirror the corresponding arrangements in Islamic finance, i.e. Ijarah, Musharakah or Mudarabah, Murabahah, and Wakalah.

8. The Bill also prescribes the method for calculating the investment return for each type of IA (clause 4: sections 10 and 11 of Schedule 17A).

9. Only qualified BA may be regarded as debt arrangement for the purposes of Cap. 112 (clause 4: section 20(2) of Schedule 17A). To be a "qualified BA", a BA must satisfy all the following five conditions (clause 4: section 12(1) of Schedule 17A):-

(a) ***the reasonable commercial return condition*** (clause 4: section 13 of Schedule 17A)
The amount of the bond return that may be payable under the terms of BA does not exceed an amount that would be a reasonable commercial return on money borrowed of an amount equal to the bond proceeds.

(b) ***the BA as financial liability condition*** (clause 4: section 14 of Schedule 17A)
The BA would be treated as a financial liability of the bond issuer in accordance with the Hong Kong Financial Reporting Standards or the International Financial Reporting Standards if the bond issuer applied those standards.

(c) ***the Hong Kong connection condition*** (clause 4: section 15 of Schedule 17A)
The alternative bonds issued under the BA of the specified scheme are either listed or marketed in Hong Kong, or are issued in good faith and in the course of carrying on business in Hong Kong, or are cleared by the Central Moneymarkets Unit operated by the Monetary Authority.

(d) ***the maximum term length condition*** (clause 4: section 16 of

Schedule 17A)
The maximum term is 15 years.

(e) ***the arrangements performed according to terms condition*** (clause 4: section 17 of Schedule 17A)
The BA and IA of a specified scheme are performed according to the terms of specified scheme.

10. Only qualified IA may be regarded as a debt arrangement (clause 4: section 21(2) of Schedule 17A). To be a "qualified IA", a IA must satisfy the following conditions (clause 4: section 12(2) of Schedule 17A):-

(a) during the whole term of the specified scheme, ***the BA of the scheme is always a qualified BA***

(b) ***the bond issuer as conduit condition*** (clause 4: section 18 of Schedule 17A)
The total amount of investment return payable, and actually paid, under the specified IA does not exceed the total amount payable, and actually paid, under the BA of the specified scheme.

(c) ***the specified IA as financial liability condition*** (clause 4: section 19 of Schedule 17A)
The specified IA is treated as a financial liability of the originator[2] in accordance with the Hong Kong Financial Reporting Standards or the International Financial Reporting Standards if the originator applied those standards.

11. For the purposes of sections 14A and 26A of Cap. 112, alternative bonds under a qualified BA and transferable on delivery are regarded as debt instruments (clause 4: section 20(3) of Schedule 17A). Bond proceeds paid by bond holders to the bond issuer are regarded as money borrowed. Payments to bond holders in addition to the amount of bond proceeds are regarded as interest payable on borrowed money. Such interest paid is deductable under section 16(2)(f) of Cap. 112. A transaction in alternative bonds is regarded as a transaction in bonds specified in Schedule 16 of Cap. 112. Hence, a non-resident is exempted from tax in respect of assessable profits from transactions in alternative bonds issued under a qualified BA. For the purposes of section 15(1)(j), (k) and (l) of Cap. 112, an alternative bond transferable by delivery is regarded as a certificate of deposit (clause 4: section 20(4) of Schedule 17A).

12. The acquisition cost under a qualified IA is regarded as money

[2] The originator is the counter-party who entered into a IA with a bond issuer of a relevant scheme (clause 4: section 2(4) of Schedule 17A).

borrowed by the originator from the bond issuer. The investment return is regarded as interest payable on the money borrowed. The bond issuer is regarded as not having any legal or beneficial interest in the specified asset under a specified scheme. Further, certain asset transactions between the originator and the bond issuer, or the business undertaking they have entered into, are to be disregarded for the purpose of profits tax under Cap. 112. The originator is regarded as the owner of any asset acquired and bears all the tax consequences in relation to the asset. The bond issuer is not liable to property tax on investment return deriving from use of land or building.

Major Amendments to Cap. 117

13. Clause 21 adds a new Part VA to Cap. 117. The alternative bonds under a qualified BA are regarded as bonds for the purposes of Cap. 117 (clause 21: new section 47E). Conveyance on sale, conveyance on sale chargeable with special stamp duty, agreement for sale, agreement for sale chargeable with special stamp duty, lease, and contract note and transfer relating to Hong Kong securities are not chargeable to stamp duty upon the following conditions being satisfied (clause 21: new section 47F):-

(a) the instrument is executed to effect a specified asset transaction between an originator and a bond issuer under a qualified IA; or

(b) the instrument is executed to effect an asset transaction between an originator and business undertaking under a qualified IA; or

(c) the instrument is executed as an agreement for a IA transaction; and

(d) the instrument is required by Cap. 117 to be made and executed for effecting a IA transaction.

Security must also be provided to the satisfaction of the Collector of Stamp Revenue for the payment of stamp duty that would, but for section 47F, have been chargeable on the instrument and other sums that would have been payable under Cap. 117.

14. For qualified IA, sections 29CA and 29DA of Cap. 117 are modified in their application to an agreement for sale or a conveyance on sale of residential property as set out in the new Schedule 6 (clause 23) to Cap, 117 (clause 21: new section 47G). The agreement or conveyance by which the originator or the bond issuer of a qualified IA acquires from a third party, or disposes to a third party, land or building which is a specified asset, is exempted from special stamp duty.

15. The Bill also provides for record keeping, mechanism for assessment of tax and stamp duty when a qualified BA or qualified IA ceases to be such, consequential amendments and other miscellaneous matters.

16. It is not a purpose of the Bill to provide for the regulation of the issue of alternative bonds.

Public Consultation

17. A two-month public consultation on the legislative proposal was conducted in March 2012. According to the Administration, a large majority of the 15 respondents welcomed the legislative objectives and proposal. A Consultation Conclusion addressing their suggestions and comments was issued on 29 October 2012. Many of the useful suggestions and comments have been taken on board in drafting the Bill after balancing the considerations of market development, evolving market needs, and anti-tax avoidance policy.

Consultation with LegCo Panel

18. The Clerk to the Panel on Financial Affairs has advised that the Panel on Financial Affairs was consulted on 5 November 2012. Various concerns were expressed by Panel members. The major ones included the proposed qualifying conditions for tax relief and their justifications and practicability, measures to address tax avoidance, regulation of sale of Islamic bonds and protection for concerned investors, and the need to put in place adequate financial, legal and cultural infrastructures supporting the development of an Islamic bond market in Hong Kong.

Conclusion

19. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. As the legislative proposal is conceived as the first step in developing Islamic finance in Hong Kong and thus, consolidating Hong Kong's status as an international financial centre and asset management centre, Members may wish to set up a Bills Committee to study the policies and the Bill in detail.

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