



THE
LAW SOCIETY
OF HONG KONG
香港律師會

LAW SOCIETY'S SUBMISSIONS

Financial Services and The Treasury Bureau's Consultation Paper Proposed Amendments to the Inland Revenue Ordinance (Cap.112) and the Stamp Duty Ordinance (Cap.117) to Facilitate Development of an Islamic Bond (i.e. Sukuk) Market in Hong Kong

General Comments

The Law Society of Hong Kong supports the Government's policy initiative to develop Islamic Financing in Hong Kong in order to enhance our status as an international finance centre. Its Revenue Law Committee has reviewed the Consultation Paper published by the Financial Services and the Treasury Bureau (Bureau) and is of the view the Bureau has prepared a clear overview of the concept of Islamic finance and the need to amend our existing tax regime in order to support the development of Islamic financing in Hong Kong.

In order to implement this policy it will be vital for the Government to educate the public, as well as the financial services industry, on Islamic financing principles, namely the payment and receipt of interest is prohibited under Islamic law. We also note Islamic law (Shariah) prohibits excessive uncertainty which includes gaming and other *haram* such as liquor, dietary restrictions, tobacco etc.

We note that care has to be taken to understand why these non-interest payments should be given preference over other dividend type payments. Where possible, care should be taken not to explain Islamic finance in terms of similarity to interest payments-reputational risk.

The existing tax framework enables market players to make use of administrative mechanisms to confirm the Hong Kong tax treatment of certain transactions, but as these are on a case by case basis it does take time for the Commissioner of Inland Revenue (CIR) to process such applications, thus the proposal to amend the Inland Revenue Ordinance (IRO) makes sense.

We note under paragraph 2.4 of the Consultation Paper the Bureau is focussing on sukuk based on a tripartite structure. We recommend the Bureau consider adopting a flexible approach to structures which can involve more than 1 Special Purpose Vehicle (SPV) or indeed none.

Paragraph 2.8 discusses disqualification of ‘previously qualified bond arrangements’ by illustrating the same in Annex 2 of the Consultation Paper. We would recommend more information be provided on the “consequences of previous approvals” in order to clarify the affect on “a previous qualified bond arrangement”.

Structure of Proposed Legislative Amendments

We agree with the proposal to create a new Part under the main legislation to provide a new special tax regime for sukuk. We note the recommendation that the CIR should provide Departmental Interpretation and Practice Notes (DIPNs) and the Commissioner of Stamp Duty should provide Stamp Office Interpretation and Practice Notes (SOIPNs) to assist market players and we suggest that such DIPNs and SOIPNs should be circulated for comment *before* the amendment bill is introduced into Legco.

Response to Questions 1- 12 in the Consultation Paper

Questions 1: *Do you agree that the description in paragraph 3.2 can accurately reflect the general features of sukuk in the market? Please explain the reasons for your views.*

Law Society’s response

1. Yes.
2. We note that a *Wakala* sukuk is becoming a popular alternative to *Musharaka* and *Mudaraba* sukuk and the Bureau should consider including this type of sukuk or others such as sukuk al-salam or sukuk al-istisna
3. Paragraph 3.2.2
 - 3.1 Would there be any difference if these SPVs were not Hong Kong entities?
4. Paragraph 3.2.7
 - 4.1 Sukuk assets could include a wide variety of investments such as schools, hospitals, energy producing structures etc. It should be emphasized that the structures should not be prohibited as explained above.

Question 2: *Do you agree that the description in paragraph 3.4 can accurately reflect the key features of the underlying structure of Ijarah sukuk in the market? Please explain the reasons for your views.*

Law Society’s response

1. Yes.

Question 3: *Do you agree that the description in paragraph 3.5 can accurately describe the asset replacement scenarios? Please explain the reasons for your views.*

Law Society's response

1. Yes, but care must be exercised in replacements as the sukuk reflect ownership in the underlying asset.
2. Paragraph 3.5.3
 - 2.1 Under Shariah "insurance" is an excluded form of cover. We note bond holders as owners should normally accept a loss but it seems that Alternative Bonds are usually marketed to compete with conventional bonds, nevertheless the underlying principles have to be recorded, unless the sukuk was a more complex structure involving a basket of assets
 - 2.2 We recommend the word "insurance" could be replaced by "*Takaful*" or an "indemnity" arrangement.

Question 4: *Do you agree that the description in paragraph 3.6 can accurately reflect the key features of the underlying structure of business-plan Musharakah and Mudarabah sukuk in the market? Please explain the reasons for your views.*

Law Society's response

1. Yes, in principle this is correct, but we note some Shariah schools do not accept this. However, if this is to be specified as a form of undertaking it could not be criticized by all.

Question 5: *Do you agree that co-ownership Musharakah sukuk structure can be accommodated under the leaseback arrangement? If not, please explain the reasons for your views and the detailed structure of this kind of sukuk in the market.*

Law Society's response

1. Yes.
2. Paragraph 3.10.1
 - 2.1 We note that 'agency' has to be emphasised. These are contracts implying a concept of *amanah* (trust akin to equitable principles).

Question 6

(a) Do you agree that the description in paragraph 3.10 can accurately reflect the key features of the underlying structure of Murabahah sukuk in the market? Please explain the reasons for your views.

Law Society's response

1. Yes.
2. Paragraph 3.10.3
- 2.1 We note it is only the Middle East which requires sukuks to adopt a tripartite structure whereas in Malaysia two-party structures under the *Shafi* school have been adopted. Banking licences have been allowed in Malaysia since 1983.

(b) The description in paragraphs 3.10.1 to 3.10.3(a) above is mainly intended to cater for a fixed-rate commodity Murabahah sukuk structure. Is it very common to see a floating-rate commodity Murabahah sukuk structure in the market? If so, please explain the detailed operations of this kind of structure.

Law Society's response

We note the following:

1. Fixed rate structures are more common than floating rate structures.
2. Sukuks have been created to compete against bonds and their structures vary in different jurisdictions. Will there be a prescribed form(s) of sukuk or will all forms be permitted?

(c) Is it very common to see replacement of asset due to destruction or loss under a Murabahah sukuk structure? If so, please explain the detailed arrangement under this scenario.

Law Society's response

1. In a two party structure there should be no need for replacement of asset concepts in a *Murabaha* sukuk since the assets are sold on day 1 and a [debt] obligation is created on that sale to the originator. The return to the Issuer is not dependant on the continued existence of the asset since it is not being leased or is not part of a shared business venture.
2. Will there be a prescribed form(s) of sukuk or will all forms be permitted?

Question 7: *Do you agree with the qualifying conditions proposed for the bond arrangement and investment arrangement under IRO? Please explain the reasons for your views.*

Law Society's response:

1. Paragraph 3.11-12

- 1.1 In general we have no objection to the comments but wish to point out that whilst the two-part structure is excluded the tripartite structure is in substance the same, save that it involves 3 parties and the obligation is given a different interpretation

Limit on return of condition

2. Paragraphs 3.12

- 2.1 The term 'debt' in this section should be replaced as an alternative bond is not a 'debt' but an obligation.
- 2.2 Why is it necessary to limit these qualified bonds which are not debt instruments in such a manner; the process appears to be cumbersome; the 'limit of return' should be left to the market?
- 2.3 As these are not debt instruments all payments for the bonds should be so considered even after the end of the term.

3. Paragraph 3.14

- 3.1 We note that to be eligible for special tax treatment a qualified bond scheme must be *regarded* as a debt arrangement under the IRO, not that it *is* a debt.

4. Paragraph 3.14.5

- 4.1 We note the proposal that the CIR will "determine a "reasonable commercial return" for a Qualified Bond Arrangement on a period by period basis even though the practice in the UK is to apply a one-time test. If this policy is adopted we recommend:
- 4.2 The CIR must be provided with adequate resources to perform this function;
- 4.3 Will the CIR conduct an initial benchmarking exercise on "a reasonable return"? Would the exercise be based on data from other Islamic bond markets or with bonds locally, and if so what factors would be taken into account? Care should be used when referring to the term "interest rates" as a more appropriate term in the Islamic finance markets would be "rate of return".
- 4.4 The CIR should issue a DIPN on benchmarking criteria.

Additional condition being considered

5. Paragraph 13.14.11

5.1 We note the intention is to require “alternative bonds issued under the bond arrangement should be listed, issued or marketed, in whole or in part, in Hong Kong. This is intended to ensure that the alternative bonds eligible for the special tax regime will have some nexus with Hong Kong.”

5.2 In relation to “listed, marketed in whole or in part” is it the intention that a threshold condition must be met?

5.3 What degree of “nexus to Hong Kong” will be required, especially for marketing?

5.4 We note that when the market for Islamic financial products matures these provisions should be reviewed.

Qualified investment arrangement

6. Paragraph 3.15

6.1 We do not agree with this proposal as there is no basis to compare a *saq* (singular) with a bond or as a debt instrument.

7. Paragraph 3.15.14

7.1 We note it is proposed that “the CIR may, for the purposes of calculation of the investment return under the investment arrangement and having regard to all the circumstances of the investment arrangement, allocate a part of the acquisition cost as attributable to each part of the assets.”

7.2 What criteria will be used?

7.3 Will the CIR have discretion? Will there be guidelines?

7.4 We suggest that where assets are to be disposed of in parts then it should be the responsibility of the Issuer to provide the CIR with an expert opinion on the value of the asset. The burden should be placed on the Issuer to satisfy the CIR the disposal is not a tax avoidance scheme and that the underlying value of the sukuk continues to comply with legal requirements. Similarly, it will be the responsibility of the Issuer to provide expert valuations on any replacement assets.

Question 8: *Do you agree that the special tax treatment in paragraphs 3.16 and 3.17 is sufficient to provide a level playing field for sukuk vis-à-vis their conventional counterparts in terms of tax liabilities? Please explain the reasons for your views.*

Law Society's response

1. No double taxation/double deduction for the relevant income streams.
 - 1.1 The proposed amendments to the IRO should make it explicit that an investment return (from Originator to Bond Issuer) or additional payment (from Bond Issuer to Bond Holders) which is deemed to be interest payments/expense, that the same payments are not taxable under other provisions of the tax act. That is, the payments are exempt from tax (including royalty withholding tax) as rental, royalties, or other income streams even if sourced in Hong Kong.
 - 1.2 Similarly deemed interest expenses which do not fulfil the deduction requirements for interest should not be deductible under other general/specific deduction provisions.
2. Ensure level playing field for onshore and offshore Bond Issuers and Bond Trustees
 - 2.1 We do not consider the commentary in paragraphs 3.16 and 3.17 provides sufficient comfort for the tax position of the Bond Issuer or trustee. There appears to be an assumption that the bond issuer/ trustee will not be carrying on business in Hong Kong. While the common practice maybe to use an offshore (e.g. Cayman Islands) special purpose vehicle (SPV) as the Issuer, there is no legal impediment from using Hong Kong issuers. As the Consultation Paper indicates the Administration wishes to promote the development of the Islamic bond market in Hong Kong, our tax rules should not artificially disadvantage the use of Hong Kong based bond issuers.
 - 2.2 To this end, we recommend consideration of a blanket profits tax exemption for the bond issuer/trustee. If this is not acceptable then there needs to be an explicit exemption for the Bond Issuer (or trustee) for investment return received from the Originator. Failure to do so will result in uncertainties as to whether they are carrying on business in Hong Kong, and whether their income is Hong Kong sourced. We note Section 2 of the IRO defines 'business' to include the letting of premises. As the majority of the sukuk market currently involves leases, this could create an additional burden for sukukuks that hold Hong Kong real estate as part of their investment portfolio and potentially put them at a disadvantage against other bond/ alternative bond issuers that do not hold Hong Kong real estate.
3. Clarify Application of Source Rules
 - 3.1 Where the payments are deemed by the IRO to be interest income, we recommend the law should go further to state how the source rules should be applied. As a majority of Hong Kong tax's source rules have been developed

by case law, it is currently unclear whether a court should consider the source rules based on the legal form of a payment, or its deemed nature. Even if payments were deemed as interest, the source rules for interest are complicated.

- 3.2 We cite as an example the following scenario: Assume for example a bond holder invests in a sukuk that holds real estate. Does one apply the source rules for rental income (location of the underlying property)? Even if the law made clear that one was to apply the source rules for interest income, should a (non-financial institution) investor apply the 'provision of credit' test, or look to where the real estate is located (akin to the originating cause of the mortgage interest)? How should the source rules apply where the bond-holder had not 'provided' credit to the borrower, but rather, bought the bonds on the secondary market where consideration is paid to the transferor/its agent?
- 3.3 We recommend incorporating the source rule on interest into the legislation in order to provide clarity.

Question 9: *Do you have any other views or comments on the proposed amendments to IRO?*

Law Society's response

Bond arrangement

1. Paragraphs 3.21 to 3.24
 - 1.1 We recommend the CIR should be given power to disregard any disqualifying event provided there are reasonable excuses for such non-compliance; currently, the CIR is only empowered to disregard any non-compliance in the delay in disposing of the specified asset (see paragraph 3.22) or with the diverse holding condition (see paragraph 3.24) but not other disqualifying events.
 - 1.2 The CIR should issue a DIPN.
2. Paragraphs 3.23 and 3.31
 - 2.1 We welcome the opportunity to conduct a comprehensive review of the different definitions of "associate" into one single definition in Section 2 of the IRO. However, it will be important to ensure provision is made for a suitable transition period to allow time for adjustments to existing arrangements which are affected.
 - 2.2 We query whether the word "relative" should be defined as we note the current definition under section 14AA of the IRO only applies to qualifying debt instruments?

Notification Requirement

3. Paragraphs 3.25 and 3.26
- 3.1 We recommend bond-issuers and originators should be required to provide annual confirmation to the CIR that no bond arrangement disqualifying event or investment arrangement disqualifying event has occurred (similar to the requirements in the case of stamp duty relief mentioned in paragraph 3.43.3).

Property Tax implications for Bond Issuers

4. The proposals addresses profits tax treatment but do not deal with Property Tax.
- 4.1 Where a sukuk holds Hong Kong real estate but the bond issuer is not a corporation that can elect to be taxed under Part 4 of the IRO (profits tax), it will be subject to property tax under Part 2 of the IRO. We recommend that consideration be given to the provision of an exemption from profits tax for bond issuers under a qualified investment arrangement.

Question 10: *Do you agree with the qualifying conditions and requirements proposed for the bond arrangement and investment arrangement under SDO? Please explain the reasons for your views.*

Law Society's response

Qualified investment arrangement

1. Paragraph 3.38.1
- 1.1 Applications for stamp duty relief should be supported by a statutory declaration made by a director or secretary of the applicant deposing to all relevant facts and exhibiting all relevant documents, in a manner similar to applications for stamp duty relief under section 45 of the SDO.

Question 11: *Do you agree that the stamp duty treatment/relief in paragraphs 3.39 and 3.40 is sufficient to provide a level playing field for sukuk vis-à-vis their conventional counterparts in terms of stamp duty liabilities? Please explain the reasons for your views.*

Law Society's response

Qualified bond arrangement

1. Paragraph 3.39
- 1.1 There is an assumption under paragraph 3.39 that most alternative bonds will not be 'stock' for stamp duty purpose as they will fall under the definition of

'loan capital'. *However, a bond that is convertible to stock is not loan capital.* We note Malaysia offers convertible sukuk but these products would not meet the qualifying requirements for tax relief in Hong Kong. In line with the policy to develop the sukuk market, it may be better for alternative bonds to be explicitly excluded from the definition of stock as a separate class of exclusion.

- 1.2 The proposed mechanism is to exclude the transfer or lease (of Hong Kong property) and the transfer of Hong Kong stock between the Originator, Bond Issuer and Business Undertaking from Hong Kong stamp duty. This is consistent with the profits tax treatment of disregarding these transactions. However, amendments to the SDO should ensure that any legal or beneficial transfers between the Originator/ bond issuer and business undertaking will be disregarded for the purpose of ascertaining liability for special stamp duty or section 45 'claw backs' i.e. in instances where the SDO requires the parties to ascertain the holding period of the transferor.

Question 12: *Do you have any other views or comments on the proposed amendments to SDO?*

Law Society's response

1. Consequences of Disqualification for Bond Holders
 - 1.1 The proposed consequences of disqualification should be considered further. The proposal in 3.48 is simply that the bond arrangement is no longer eligible for stamp duty treatment similar to conventional bonds under the SDO. At law, the bond holder of an alternative bond is holding a note issued by the bond issuer and that may fall within the definition of "stock". Further, the bond holder also has a small beneficial interest in the underlying property of the sukuk that may be Hong Kong stock. Would the parties be liable to stamp duty on the transfer of two sets of rights? How would the investor's proportionate interest be practically calculated and how would the amount of stamp duty be ascertain/ collected?
2. Application of section 21 of the SDO
 - 2.1 Section 21 of the SDO prohibits the passing of dividends or interest on Hong Kong stock. It is a peculiar provision the purpose of which is not entirely clear. We recommend that the SDO should be amended to explicitly dis-apply this section to alternative bond arrangements.

The Law Society of Hong Kong

5 June 2012

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