Hong Kong takes steps towards becoming a centre for Islamic Finance

Since 2007, Hong Kong has been looking at ways to encourage the development of a sukuk market in Hong Kong, which has historically been limited by the potentially adverse tax treatment of such instruments.

On 19 July 2013, the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 was gazetted, conforming the tax treatment for Islamic securities to conventional debt securities.

It is hoped that the development of a sukuk market will help to reinforce Hong Kong's position as an international financial centre by widening its spectrum of financial products and range of market participants.

Recent developments in Hong Kong

Prior to the coming into force of the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 (the "**Amendment Ordinance**"), the benefit of certain tax allowances could not be claimed under a sukuk transaction. For example, profit (coupon) payments made to the sukukholders from the economic return of the assets would not be treated as interest payments and hence were not tax-deductible for the issuer. Any depreciation allowances could also not be claimed as the underlying assets would be held by a special purpose vehicle, and no longer by the originator itself.

On 19 July 2013, amendments were made to the Inland Revenue Ordinance (Cap. 112) ("**IRO**") and Stamp Duty Ordinance (Cap. 117) ("**SDO**") through the Amendment Ordinance. These amendments are not intended to confer preferable tax treatment for sukukholders. Instead, the changes aim to create a more "level playing field" by conforming the tax treatment for conventional bonds and sukuk. Broadly speaking, such changes allow a qualifying sukuk transaction to be deemed a debt arrangement, entitling the sukukholder and the originator to claim the benefit of certain tax deductions and concessions applicable to conventional bonds.

Background – what is a sukuk?

Under Islamic law, money is regarded as having no intrinsic value, no time value and is seen merely as a means of facilitating trade. Accordingly, the payment and receipt of interest in Islamic finance transactions is prohibited and any obligation to pay interest is also considered void. The sukuk product was therefore developed as a result, to commercially replicate conventional interest bearing bonds in a *Shari'a*-compliant manner.

A sukuk is an asset based investment, where investors own an undivided interest proportional to their investment in a portfolio of underlying assets, as evidenced by a sukuk certificate. A trust is declared over the relevant assets in favour of the investors, and each investor becomes entitled to the economic returns generated by the assets, proportional to their respective investments. For a more detailed description of sukuk, please refer to our Client Briefing "*Introduction to Sukuk*" *(March 2013)*.

Implications of a sukuk structure

Despite achieving an economic result equivalent to conventional bonds, unintended tax and other regulatory implications applicable to certain features of a sukuk transaction may render it a less commercially attractive financial instrument by comparison. A typical sukuk structure involves the establishment of a special purpose vehicle and the subsequent use of underlying assets to generate the flow of funds to the special purpose vehicle and therefore to sukukholders. The flow of funds can be generated through a number of different structures which may involve the sale, transfer, lease or other potential use of the assets. However, such activities may be subject to certain stamp duty, property taxes or profits taxes not otherwise applicable to a typical conventional bond structure.

The legislative changes

In a similar approach to jurisdictions such as the United Kingdom, the IRO and SDO amendments cater for sukuk structures by adopting a prescriptive, secular approach. Under the IRO and SDO, the corporate is termed the "**originator**", and the special purpose vehicle established by such originator to issue the sukuk (called "**alternative bonds**") is termed the "**bond-issuer**". The sukuk structure is described under both ordinances as an "**alternative bond scheme**", which comprises a "**bond arrangement**" and an "**investment arrangement**". An alternative bond scheme would be eligible for the tax deductions and concessions applicable to conventional bonds if both its bond arrangement and investment arrangement components fulfil certain statutory qualification criteria.

Component 1: the qualified bond arrangement

The bond arrangement prescribed under the IRO and SDO essentially reflects the standard arrangement between the issuer and the investors in a sukuk transaction. Broadly speaking, the prescribed bond arrangement must have the following features:

- the bond-issuer is a special purpose vehicle established solely for the scheme;
- bond-holders pay a sum of money to the bond-issuer;
- the bond-issuer enters into an investment arrangement with the originator (as discussed below) on behalf of the bond-holders;
- the bond-issuer issues instruments (i.e. sukuk) to the bond-holders evidencing their rights and interests in the underlying assets constituted by the investment arrangement; and
- the bond-issuer undertakes to make a payment to the bond-holders to redeem the alternative bonds and to make other additional payments (either during or at the end of the specified term) from either the investment return or proceeds of disposal from the relevant investment arrangement used.

In order to be a "**qualified bond arrangement**" entitled to the tax treatment of a debt arrangement, the bond arrangement needs to satisfy the following conditions:

- **Reasonable commercial return condition**: both the maximum total amount of the bond return payable under the scheme and the total amount actually paid to the bond-holders must not exceed an amount that would be a reasonable commercial return on the money borrowed of an amount equal to the bond proceeds;

- **Bond arrangement as financial liability condition**: the bond arrangement is treated as a financial liability of the bond-issuer in accordance with the Hong Kong Financial Reporting Standards or the International Financial Reporting Standards;
- **Hong Kong connection condition:** the alternative bonds are either listed on a stock exchange in Hong Kong, are issued in good faith in the course of carrying on business in Hong Kong, are marketed in Hong Kong, or are lodged with and cleared by the Central Moneymarkets Unit (the "**CMU**") operated by the Monetary Authority of Hong Kong;
- **Maximum term length condition:** the specified term of the alternative bond scheme must not exceed 15 years; and
- **Arrangements performed according to terms conditions**: the bond arrangement and investment arrangement in the scheme are performed according to their prescribed terms.

Component 2: the investment arrangement

An investment arrangement refers to the arrangement between the bond-issuer and the originator, and must be a "**specified investment arrangement**". In order to be a specified investment arrangement, the investment arrangement must be one of the arrangements below, which reflect the five most commonly used sukuk structures in the market (namely, *ijara*, *musharaka*, *mudaraba*, *murabaha* and *wakala* structures):

(A) Lease arrangement

The lease arrangement corresponds to an *ijara* structure. Under this arrangement, the bond-issuer will use the proceeds from the sukuk to acquire certain assets from the originator, and will hold those assets for a specified term. During this term, the bond-issuer leases the assets back to the originator in return for periodic lease payments. At the end of the specified term, the bond-issuer disposes of the asset to the originator in return for an amount equal to the amount outstanding under the alternative bonds.

(B) Profits sharing arrangement

Under the profits sharing arrangement, the bond-issuer and the originator form a business undertaking whereby the originator carries on the business undertaking to generate an investment return. The bond-issuer will contribute the sukuk proceeds to the business undertaking while the originator will either contribute a sum of money or property in kind (in which case the arrangement corresponds to a *musharaka* structure) or its expertise and management skills (in which case the arrangement corresponds to a *mudaraba* structure). During the specified term of the business undertaking, any profits generated are distributed between the bond-issuer and originator in accordance with their agreed profit-sharing ratios whereas any losses incurred will be borne either by the bond-issuer and originator in proportion to their capital contributions (as would be the case under a *musharaka* structure) or by the bond-issuer solely (as would be the case under a *mudaraba* structure). At the end of the specified term, the bond-issuer is to dispose of its share in the business undertaking to the originator in return for an amount equal to the amount outstanding under the alternative bonds.

(C) Purchase and sale arrangement

The purchase and sale arrangement corresponds to a *murabaha* structure. Under this arrangement, the bond-issuer acquires an asset from a third party upon its immediate payment of the sukuk proceeds to the third party and immediately re-sells that asset to the originator for an amount equal to its acquisition cost plus a mark-up to generate an investment return. The originator may either immediately dispose of the asset to another third party or retain it for its own use. During the specified term and by the end of such term, the originator will have paid back the purchase price which will be an amount equal to the bond-issuer's acquisition cost together with the mark-up.

(D) Agency arrangement

The agency arrangement corresponds to a *wakala* structure. Under this arrangement, the bond-issuer appoints the originator to act as its agent to acquire an asset using the proceeds from the alternative bonds and to hold it on its behalf for a specified term to generate an investment return. During the specified term, the originator will pay to the bond-issuer the income generated from the management of the asset, minus any agency fee or incentive fee to which it is entitled. By the end of the specified term, the originator will dispose of the asset in return for the proceeds of disposal and pay an amount equal to the amount outstanding under the alternative bonds to the bond-issuer.

In addition to being a specified investment arrangement, the investment arrangement must also fulfil the following conditions to be a **'qualified investment arrangement'** in order to be eligible for the same tax treatment as conventional bonds:

- **Bond-issuer as conduit condition**: (a) the maximum total amount of the investment return payable under the investment arrangement will not exceed the maximum total amount of the bond return payable under the terms of the bond arrangement in the scheme and (b) the total amount of investment return actually paid under the investment arrangement does not exceed the total number of the bond return actually paid under the bond arrangement in the scheme; and
- **Investment arrangement as financial liability condition**: the investment arrangement is treated as a financial liability of the originator under the Hong Kong Financial Reporting Standards or the International Financial Reporting Standards.

(E) Innovative investment arrangement

The above specified investment arrangements are the initial arrangements that have been recognised under the Amendment Ordinance and which correspond to the five most commonly used sukuk structures at present. However, as the sukuk market is constantly evolving and as new sukuk structures may emerge from time to time as a result of market innovation, the amendments that have been made to the IRO and SDO by the Amendment Ordinance empower the Financial Secretary of Hong Kong to broaden the scope of specified investment arrangements by adding new sukuk structures as specified investment arrangements or amending the specific features of existing specified investment arrangements in the relevant legislation. In order to facilitate this process, any further amendments will be carried out by way of a notice published in the official gazette of the Hong Kong SAR Government and subject only to negative vetting by the Legislative Council (instead of a full-scale legislative procedure).

Equal tax treatment for a qualified alternative bond scheme

An alternative bond scheme comprising a qualified bond arrangement and a qualified investment arrangement (as described above) will be a "**specified alternative bond scheme**" and therefore eligible for the same treatment under the amended IRD and SDO as a conventional bond. In particular, the IRO and SDO can now confer the following special tax benefits and concessions to the bond-holders, the bond-issuer and the originator.

(A) For the benefit of the bond-holders:

Under the amended IRO:

- The additional payments payable by the bond-issuer to the bond-holders under the qualified bond arrangement are to be regarded as interest payable on that money borrowed by the bond-issuer from the bond-holders. As such, the additional payments will be treated as tax-deductible income of the bond-holders.

- The bond-holders are to be regarded as not having any legal or beneficial interest in the underlying assets of the alternative bond scheme, such that no unintended tax implications for the bond-holders will arise from the declaration of trust by the bond-issuer over the bond proceeds and underlying assets of the scheme for the bond-holders.
- The bond-issuer is to be regarded as not being a trustee in respect of the underlying assets of the alternative bond scheme so that the scheme will not fall within the definition of a collective investment scheme for profits tax purposes.
- The issue of an alternative bond under the qualified bond arrangement is to be regarded as a debt issue for the purpose of the definition of a "debt instrument" and the making of the redemption payment for the alternative bond is to be regarded as the redemption on maturity or presentment of a debt instrument. As such, the tax concessions and exemptions for a "qualifying debt instrument" are extended to the alternative bond scheme in the same way as they are applied to conventional bonds.
- The making of the redemption payment for the alternative bond is to be regarded as the redemption on maturity or presentment of a certificate of deposit. In this way, the disposal gains before maturity and the premium/discount element received on maturity will be treated as trade receipts for profits tax purposes.
- The exemption in favour of non-resident persons from profits tax is extended to non-resident bond-holders by virtue of deeming the alternative bond issued under the qualified bond arrangement as a "bond".
- A qualified bond arrangement is not to be regarded as a mutual fund, unit trust or similar investment scheme so that the alternative bond issued under the qualified bond arrangement can enjoy certain tax exemptions in the same way as conventional bonds.

Under the amended SDO:

- The bond-holders under a qualified bond arrangement are to be regarded as not having any legal or beneficial interest in the underlying assets of the alternative bond scheme. As such, transfer of an alternative bond would not be treated as transfer of the underlying assets for stamp duty purposes.
- An alternative bond issued under a qualified bond arrangement is not to be regarded as falling outside the scope of "loan capital", the transfers of which are not subject to stamp duty.

(B) For the benefit of the bond-issuer and originator:

Under the amended IRO:

- The additional payments payable on alternative bonds under the qualified bond arrangement by the bond-issuer are to be regarded as interest payable on debentures or instruments by the bond-issuer, thereby entitling the bond-issuer to deduct such payments from its tax liabilities.
- The investment return under the qualified investment arrangement is to be regarded as interest payable on the money borrowed by the originator from the bond-issuer, thereby entitling the bond-issuer to treat such investment returns as interest payable on a debt arrangement for profits tax purposes.
- The bond-issuer is to be regarded as not having any legal or beneficial interest in the underlying assets of the alternative bond scheme, thus

removing any unintended tax implications for the bond-issuer as a result of the bond-issuer's acting as trustee of the underlying assets for the bond-holders.

- The additional payments payable by the bond-issuer on alternative bonds issued under the qualified bond arrangement are tax-deductible as if they were interest payable on money borrowed from an associated corporation of the originator, notwithstanding that the bond-issuer may be an orphan special purpose vehicle.
- Any transaction of the underlying assets between the originator and the bond-issuer, or any asset transaction between the originator and the business undertaking, under the qualified investment arrangement is to be disregarded for profits tax purposes.
- Any income, expenditure, profits, gains or losses arising from or attributable to any underlying assets, or any asset held by the business undertaking, under the alternative bond scheme are to be treated as income, expenditure, profits, gains or losses of the originator. As such, the originator will be entitled to depreciation allowances associated with any such asset.

Under the amended SDO:

- Stamp duty relief is granted to instruments executed in relation to transactions of Hong Kong immovable property or Hong Kong stock between the originator and the bond-issuer or between the originator and the business undertaking under a qualified investment arrangement. Any such transaction arising from a replacement of asset under the leasing arrangement and the profits sharing arrangement is also covered. As a result, an alternative bond scheme is placed on equal footing with conventional bonds which do not normally require the transfer or lease of assets.

Concluding remarks

The legislative changes to the IRO and SDO have been much anticipated and are a welcome development in Hong Kong. Through these changes, it is hoped that Hong Kong will begin to see local issuers taking advantage of the fact that some of the previous impediments to the issuance of sukuk in Hong Kong have now been removed in order to allow them to begin issuing sukuk. For these issuers, it would allow them to diversify their funding bases by opening new markets to them, particularly in South East Asia and the Middle East and North African Regions. As for Hong Kong, the development of a sukuk market which builds on its existing strengths in the financial services industry would broaden its financial markets and reinforce its position as a leading international financial centre.

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