

## Islamic Finance – Japanese law reforms

A recent amendment to the Japanese laws will facilitate *Shari'a*-compliant financing structures within Japan. Historically, it had been difficult to structure *Shari'a*-compliant financing structures in Japan due to a number of factors, including the tax treatment of the distribution of profits to overseas Islamic investors. However, a recent amendment to the Japanese Asset Securitisation Law together with certain tax reforms have made investing in Japan in a *Shari'a*-compliant manner more attractive and have helped to level the playing field between conventional financing and Islamic financing for such investments in Japan. These amendments came into effect on 24 November 2011.

This client briefing will begin by re-visiting the basics of the *sukuk* and *sukuk-al-ijara* and discusses the consequences of the latest legislative amendments for the development of Islamic finance in Japan.

### **Sukuk and Sukuk-al-Ijara**

A number of different Islamic financing techniques and products have been developed in accordance with Islamic principles and jurisprudence (*Shari'a*) and one of these is the *sukuk*. Although the *sukuk* is sometimes referred to as an "Islamic bond", it is better described as an asset based investment as the investor has an undivided beneficial ownership interest in underlying assets which is proportionate to such investor's investment. The *sukuk* certificate evidences this ownership interest. Monies raised by the issue of the *sukuk* are used to invest in the underlying assets and a trust is declared over such assets for the benefit of the investor, who is entitled to all the benefits that the ownership interest entails including a proportion of the return or profit generated by the assets.

The *ijara* is a *Shari'a*-compliant lease. It is a hybrid between an operating lease and a finance/capital lease with certain "ownership" risks, such as the obligation to undertake major maintenance and structural repairs of the leased assets and the obligation to insure the assets, remaining with the lessor. The lessor may appoint an agent, usually the lessee itself, to carry out these duties on its behalf under a servicing agreement. In a simple *sukuk-al-ijara* structure the originator will sell certain physical assets to a special purpose vehicle (SPV). The SPV will finance this acquisition with cash raised by the issue of the *sukuk*. The SPV will then lease the same physical asset to a third party, often the originator itself or a third party connected to the originator. The rental payments under the lease will mirror the profit payments under the *sukuk* and the cash flow from the lease rentals will be used to service the profit payments under the

#### Key issues

#### **Sukuk and Sukuk-al-Ijara**

#### **The 2011 Japanese law reform**

#### **Requirements under the Japanese Asset Securitisation Law**

#### **Tax treatment**

#### **Conclusion and observations**

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*sukuk*. From a *Shari'a* perspective, the SPV will need to have ownership rights prior to granting the lease. A sufficiently long headlease will sometimes be deemed, from a *Shari'a* perspective, to be akin to an ownership interest and therefore sufficient for this purpose. Each investor would therefore own a proportionate interest in the underlying assets and any revenue being generated by such assets and the payment of the profit under the *sukuk* can be justified as a result of the risks and rewards of such ownership.

Diagram 1 illustrates a classic *sukuk-al-ijara* structure.

### The 2011 Japanese law reform

Before the reform, distribution of profits under *sukuk* were, unlike payments of interest under conventional bonds, believed to be subject to 15% withholding tax where a Japanese company issued *sukuk* to foreign investors. This was an impediment to the development of the *sukuk* market in Japan. As a result of the reform, tax exemption will be given to foreign investors who purchase "Bond-Type Beneficial Interests" which are quasi-bond beneficial interests (*shasai teki jyueki ken*) of a "Specified Purpose Trust" (SPT) established under the Asset Securitisation Law, which will be the basis for the issuance of *sukuk* in Japan. Diagram 2 illustrates a *sukuk-al-ijara* structure using Bond-Type Beneficial Interests.

### Requirements under the Japanese Asset Securitisation Law

In order to issue Bond-Type Beneficial Interests, the following items need to be provided in the SPT Agreement in accordance with the new Article 230 of the Asset Securitisation Law and the relevant Cabinet Order and Cabinet Office Ordinance:

- (1) *Amount of distribution* - The amount of each distribution must be set out in the SPT Agreement in the form of a pre-determined amount (or an amount determinable based on a method for calculating interest in the financial market).
- (2) *Structure of payments* - The principal must be redeemed at one or more pre-determined points in time or upon the occurrence of certain conditions such as following an event of default.
- (3) *Voting rights* - The holders of the Bond-Type Beneficial Interests are not granted voting rights save for certain prescribed resolutions such as in relation to the amendment and termination of the SPT Agreement.
- (4) *Other conditions* – The distribution of profits arising from management or disposition of trust assets is made every month, three months, six months or one year, and the principal amount of the Bond-Type Beneficial Interests is not changed except as a result of redemptions thereof in whole or in part.
- (5) *Creditworthiness of originator* – If the Bond-Type Beneficial Interests contain a condition that the settlor is required to repurchase the trust assets under the SPT Agreement or the SPT Agreement provides any other conditions as provided in the Cabinet Office Ordinance that the settlor's creditworthiness has a material effect on the investors' investment decisions, the settlor is required to give notice to the trustee without delay under the SPT Agreement if an event affecting, or likely to affect, the creditworthiness of the originator has occurred or may possibly occur. The reason for this requirement is that such Bond-Type Beneficial Interests have been structured as asset based structures (as opposed to asset backed structures) where the originator's creditworthiness is a material consideration for investors both at the time of deciding whether to invest as well as during the life of the investment.

## Tax treatment

Preferential tax measures have also been introduced for the Bond-Type Beneficial Interests of an SPT held by investors who do not have a permanent establishment in Japan.

- (1) *Profit distributions and gains on redemption* - Interest and gains on redemption from book-entry corporate bonds (issued on or before 31 March 2013) received by non-resident individuals or foreign companies are tax exempt under certain conditions. This rule has been expanded to cover profit distributions and gains on redemption from book-entry Bond-Type Beneficial Interests (issued on or before 31 March 2013) of SPTs.
- (2) *Capital gains* - Capital gains arising from the disposal of Bond-Type Beneficial Interests by a foreign company or a non-resident individual will not be taxed in Japan.
- (3) *Tax treatment of SPTs* - An SPT will effectively be a tax pass-through vehicle. Profit distributions paid by a SPT are deductible in calculating taxable income of the SPT provided that the qualifying requirements are satisfied.

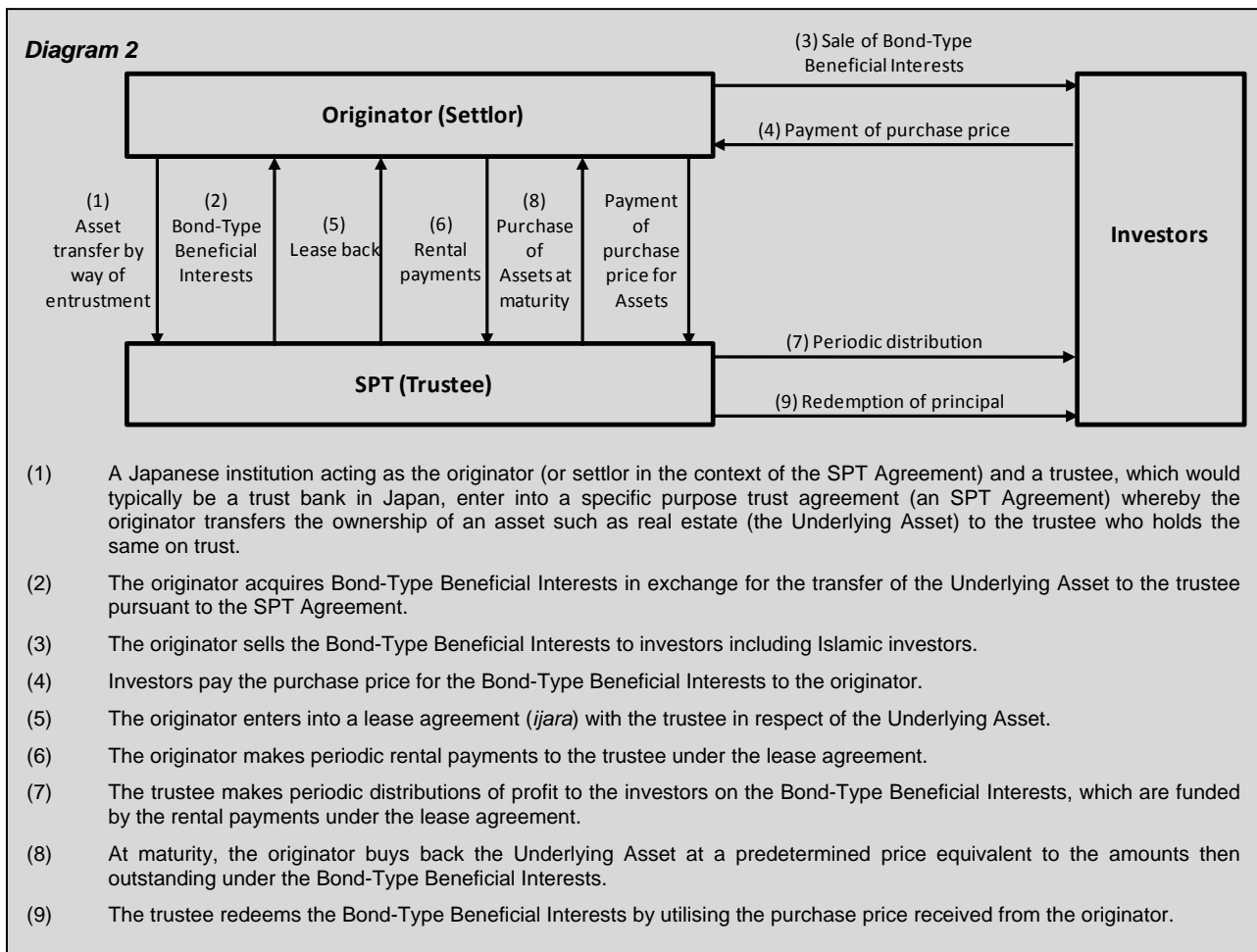
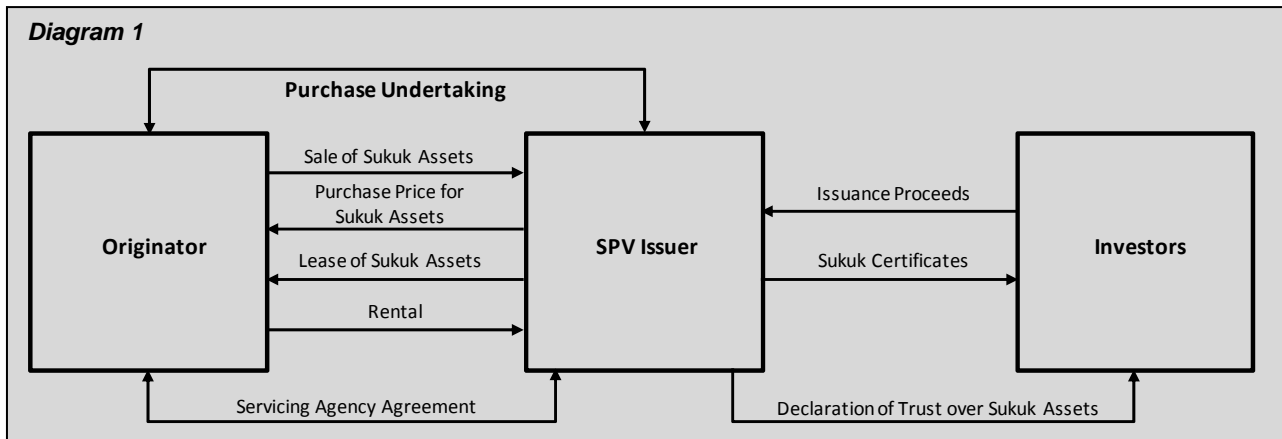
It is noted that the requirement for more than 50% of the instruments to be offered as part of a domestic offering has been removed from the qualifying requirements, a reform clearly aimed at attracting foreign investors in investing in Bond-Type Beneficial Interests.

- (4) *Exemption from tax imposed on the transfer of Underlying Assets* - If the originator repurchases assets entrusted to the SPT on the termination of the SPT Agreement, the repurchase will be exempt from taxes if certain conditions are satisfied. This is particularly significant in the case of Underlying Assets being real estate as a transfer of real estate assets can otherwise attract significant acquisition and registration taxes.

## Conclusion and observations

These reforms to the Asset Securitisation Law and tax laws have levelled the playing field significantly between conventional financing methods and Islamic financing methods in Japan. The legal platform has now been put in place to open up the Japanese market to investors who require the investment structure to be *Shari'a*-compliant. They also facilitate the ability of Japanese institutions to utilise assets on their balance sheet to raise asset based funding from capital markets investors who can only invest in *Shari'a*-compliant structures. These reforms in Japan are very much welcome as they are consistent with the current global trend for financial centres such as the United Kingdom, France, Singapore, Hong Kong and other jurisdictions without a tradition of Islamic jurisprudence to carry out legislative changes to create a legal environment where Islamic finance can flourish.

*Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.*



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