Linklaters

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Proposed Amendments to the Inland Revenue and Stamp Duty Ordinances to facilitate development of an Islamic Finance Market in Hong Kong.

Introduction

The Hong Kong Government has taken a major step towards developing Islamic finance in Hong Kong. This goal was first established by the then Chief Executive Donald Tsang in his 2007-2008 Policy Address and repeated in Policy Addresses and the Financial Secretary's Budgets in subsequent years. The Government believes that the development of Islamic finance in Hong Kong will help diversify Hong Kong's financial platform and enhance its competitiveness as an international financial centre.

Levelling the Playing Field

Shariah principles prohibit certain activities, including the payment and receipt of interest so no interest or coupon payments may be made or received on loans or bonds. To comply with Shariah principles the structuring of commercially equivalent Islamic instruments or sukuk often involves the transfer of underlying assets and setting up of special purpose vehicles, which may give rise to additional tax and stamp duty liability when compared to conventional bonds and put the structures at a fiscal disadvantage. The Government has decided to introduce amendments to the Inland Revenue Ordinance (Cap. 112) ("**IRO**") and Stamp Duty Ordinance (Cap. 117) ("**SDO**") to level the playing field for common types of sukuk vis-à-vis conventional bonds in terms of profit tax, property tax and stamp duty liabilities.

Introduction of Bill

To this end, after consulting the market in March 2012 and publishing its conclusions in November 2012 the Government gazetted the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2011 (the "**Bill**") earlier this month.

The Bill sets out five common examples of Islamic financing, namely Ijarah, Musharakah, Mudarabah and Murabahah as well as Wakalah (added as a result of consulting the market) aiming to give them the same tax treatment as compared with conventional bond issues. Please see Schedule 1 for a brief summary of each of these structures. The rationale is to establish parity and no additional advantages or incentives will be given to the sukuk structures over and above those afforded to conventional bonds. The Bill has also built in flexibility to enable the expansion of the scope of the sukuk structures in the IRO and SDO by way of subsidiary legislation when necessary in the future.

Contents

Summary of Bill

The amendments apply to sukuk adopting a tripartite structure, specifically an investment arrangement between the issuer and the investors and a back to back investment arrangement between the issuer and the originator. The amendments in the Bill provide for a set of essential features and qualifying conditions that must be satisfied in order for such arrangements to qualify to enjoy special tax treatment and stamp duty relief. They also set out the obligations of the originator and issuer after the special tax and stamp duty treatment has been applied and the circumstances under which such arrangements will become disqualified from the special treatment and the consequences of such disqualification. The Government has indicated it wishes to strike the correct balance between addressing tax avoidance issues and promoting the development of the Islamic finance market in Hong Kong.

The Bill does not use the Shariah terminology but has adopted a "religion-neutral" approach using the term "alternative bond scheme" or "ABS" to describe the structures which will benefit from the proposed tax treatment. (The use of the abbreviation ABS is rather unfortunate since it more commonly refers to "asset-backed securities". This is doubly confusing in that Islamic financing is often asset *based* rather than asset backed.)

To qualify for the relaxations in tax treatment, the alternative bond scheme and investment arrangement must meet strict conditions defined in the Bill.

In outline, the conditions require that the arrangements must be treated as a liability of both the issuer and the originator under HKFRS or IFRS; must not return to investors more than a commercially reasonable return on a comparable bond, with the alternative bond issuer as a pure pass-through conduit; must have maximum term of 15 years; must be marketed in or otherwise connected with Hong Kong (e.g. by listing on HKSE or clearing in CMU); and must actually be operated in accordance with the documentary terms.

Inland Revenue Ordinance

The Bill sets out how the qualified bond arrangement and qualified investment arrangement are to be regarded as debt arrangements for the purposes of several provisions of the Inland Revenue Ordinance including Section 14A Qualifying Debt Instruments, Section 15 Certain amounts deemed Trading Receipts, Section 16 Ascertainment of Chargeable Profits, Section 20AC Certain profits of non-resident persons exempt from tax and Section 26A Exclusion of certain profits from tax. The tax exemptions and concessions for conventional bonds are thereby extended to alternative bond schemes.

As mentioned above the Bill empowers the Financial Secretary to amend the relevant part of the Act to provide for alternative structures as the market develops.

Stamp Duty Ordinance

Part IV of the Bill provides amendments to the Stamp Duty Ordinance allowing stamp duty relief for instruments executed in relation to the bond arrangement or investment arrangement in a specified alternative bond scheme if certain conditions are met, intended to reproduce the stamp duty position as it would apply to conventional bonds.

The Bill contains mechanisms including record keeping to address tax avoidance issues and the consequences when a disqualifying event occurs.

Looking Ahead

It is to be hoped that this progressive step will hasten the development of Islamic financing in Hong Kong, and we anticipate the first alternative bond scheme will be brought to the market shortly after the Bill has been enacted. Although not envisaged at the time the policy was first announced, it is widely predicted that Islamic finance instruments denominated in renminbi could be a distinctive, and distinguishing, feature of the Hong Kong market.

Linklaters has considerable experience in structuring and documenting Islamic finance transactions in Asia - see our track record– including RMB-denominated sukuk.

Schedule 1

Key Types of Islamic Instruments*

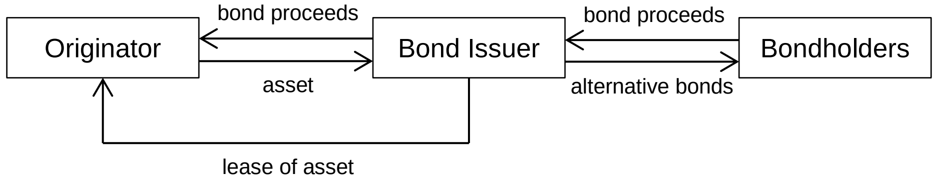
1 Ijara

1.1 An *Ijara* contract centres around a lease. The Issuer will purchase an asset from another company (the "**Originator**") using funds obtained from the issue of the alternative bonds and then lease that same asset back to the Originator for a rent. The *Ijara* is structured so that at the end of the lease period the asset will remain with the Originator, or the Originator will have an option to purchase the asset.

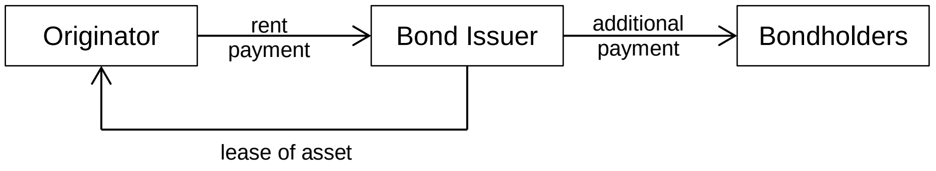
1.2 On any additional payment date (as a substitute for interest), rent will be paid by the Originator to the Issuer for the use of the asset which will then be transferred on to the Bondholders.

1.3 At the maturity of the alternative bonds and termination of the lease the asset will remain with the Originator and the income received by the Issuer during the period of the lease, together with the proceeds of disposal (if any), will be used to pay the principal amount of the alternative bonds on their redemption.

At the Issue of the Alternative Bonds:

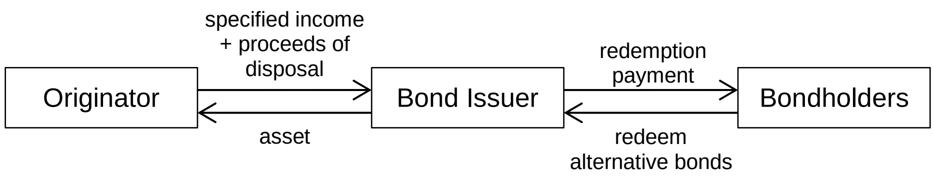


On any Additional Payment prior to Maturity of Alternative Bonds:



* Diagrams and terminology based on those set out in the FSTB Consultation Paper.

On Maturity:



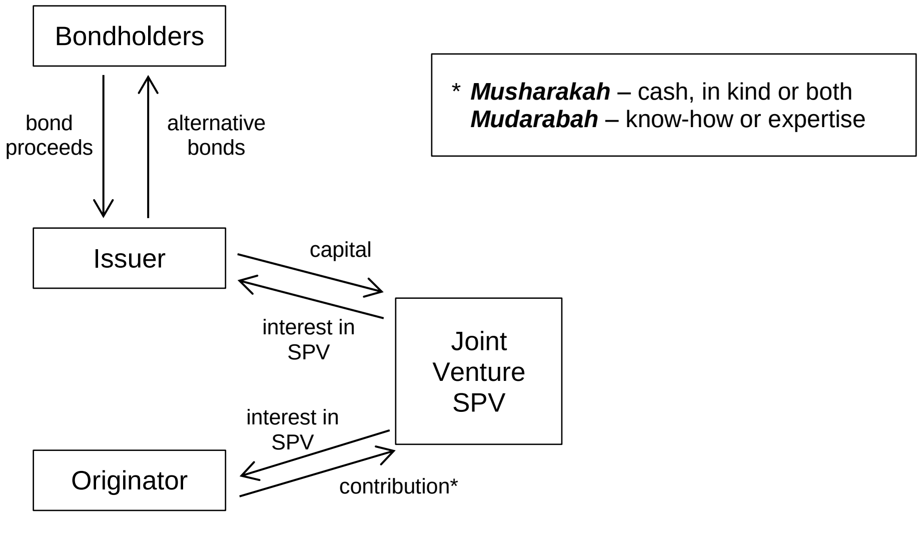
2 Musharakah or Mudarabah

Both *Musharakah* and *Mudarabah* structures involve joint ventures between two or more parties.

2.1 In a *Musharakah* arrangement the Originator and the Issuer will contribute capital (the Issuer's can be in cash or in kind). Profits realised at the end of the joint venture period (and on maturity of the alternative bonds) will be split between the two parties at a pre-arranged ratio and used to pay back the principal amount due under the alternative bonds. Any losses will have to be borne by both the Issuer and the Originator (a sinking fund is created and relied on to cover any payments due under the alternative bonds when the joint venture has not created sufficient profits).

2.2 In a *Mudarabah* arrangement only the Issuer will contribute capital and the Originator will instead contribute know-how and expertise. As with the *Musharakah* arrangement, profits realised at the end of the joint venture will be shared between the parties at a pre-agreed ratio. Unlike *Musharakah*, however, losses will only be borne by the Issuer.

At the Issue of the Alternative Bonds:



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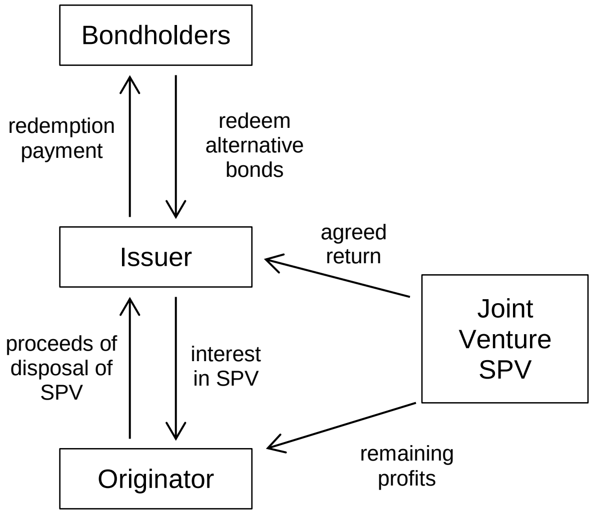


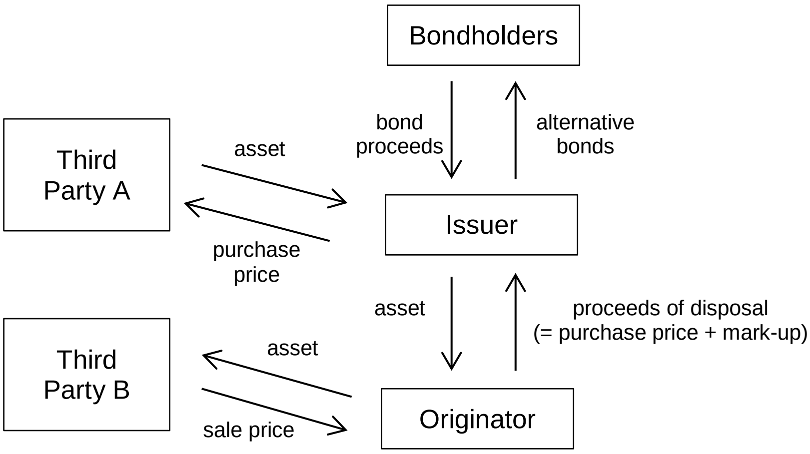
3 Murabahah

3.1 The *Murabahah* structure involves selling goods with a pre-agreed mark-up. An asset is purchased by the Issuer at a certain cost (using funds obtained from the issue of the alternative bonds). The Issuer then sells the asset on to the Originator at the cost of acquisition but with an additional mark-up. The Originator then sells the asset to another third party for an amount which matches the total cost paid by the Originator on immediate payment terms.

3.2 The Originator will pay the Issuer the total acquisition cost on deferred payment terms. The Issuer will use funds which are paid before maturity to provide the bondholders with additional payments during the life of the bond.

3.3 On Maturity, the Originator will have completed the payment terms of the sale and the Issuer will use the funds it has received to repay the principal amount of the alternative bonds to the bondholders.

At the Issue of the Alternative Bonds:



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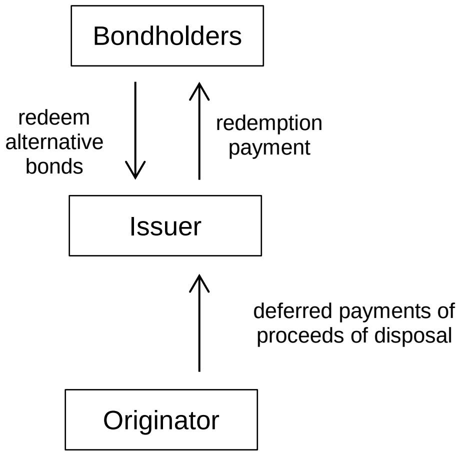
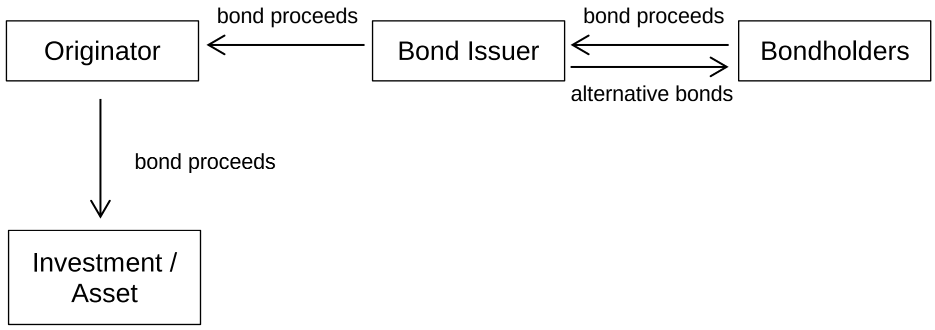


4 Wakalah

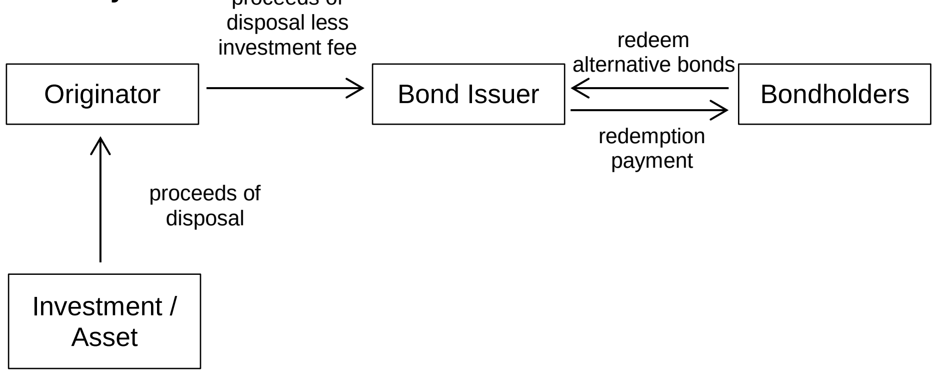
4.1 The Wakalah structure involves an agency relationship between the Originator and the Issuer. The Originator uses funds received from Bondholders to make an investment or purchase assets.

4.2 On maturity of the alternative bonds the Originator will sell the asset or realise their investment. The Originator is entitled to a fee for its services as well as a proportion of any profits which are above a pre-agreed profit rate. The funds released to the Issuer on the asset sale will be used to redeem the alternative bonds.

At the Issue of the Alternative Bonds:



On Maturity:



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