Tax alert

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Hong Kong government launches consultation on legislative amendments to develop Islamic finance in Hong Kong

In March 2012, the Hong Kong government launched a two month consultation on proposed amendments to the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO) to promote the development of an Islamic bond market in Hong Kong. This policy initiative was first articulated by the Chief Executive, Donald Tsang, in his policy address in 2007 and most recently by the Financial Secretary, John Tsang Chun-wah in the 2012-13 Hong Kong Budget (see Tax alert issue 3 – February 2012).

Background

Hong Kong is the leading financial services centre in the Asia Pacific region. As a global and regional financial hub, Hong Kong is committed to ensuring that it has a legal and tax framework to support the development of Islamic financing in the region. There is an ever increasing demand for Islamic financing products from both investors and borrowers and Hong Kong needs to provide a platform to promote the sector in the region. The introduction of Islamic finance in Hong Kong will help to diversify its financial platform and add to the breadth and depth of the financial market by widening the spectrum of financial products and the range of market participants. This will, in turn, reinforce Hong Kong's position as an international finance centre.

Islamic finance refers to financial activities that are in compliance with the requirements, restrictions and prohibitions imposed by Islamic law (Shariah). Islamic finance has fast become part of the mainstream financial services industry around the globe. Major financial markets, like the UK, Singapore, Japan, Australia and Ireland, have all been developing their Islamic finance offerings in their respective jurisdictions. From a participant's perspective, the principal issue is ensuring that the tax treatment of an Islamic financing product is the same as a conventional financing arrangement.

The payment of interest is prohibited under Shariah and returns are structured as distributions of profit or rental payments. Arrangements typically involve the issue of Sukuk. Sukuk are asset-based or asset-backed instruments representing Sukuk-holders' undivided ownership in the underlying asset and their right to receive profits generated by the asset.

The issue of Sukuk, therefore, typically involves more complex structures, such as setting up a special purpose vehicle (SPV) and multiple transfers of the underlying asset for the purposes of generating returns in the form of rental income, trading gains or profits sharing in lieu of interest. Such structures may attract additional profits tax, property tax and stamp duty charges which, in the absence of special rules, place Sukuk issues at a disadvantage when compared with their conventional counterparts. Thus, the existing tax regime is a major impediment to the development of a Sukuk market in Hong Kong.

Current tax impediments

The main tax impediments involved in a Sukuk issue are as follows:

- Where the underlying asset is Hong Kong immovable property or Hong Kong stock, additional stamp duty charges will be incurred as a result of the multiple transfers and lease of the underlying asset between the originator and the SPV, which would not have been implemented but for Shariah purposes

- The coupon payments made by the SPV to Sukuk-holders and certain periodic payments from the originator to the SPV are not deductible for profits tax purposes as they are not interest payments in legal form

- The originator of the Sukuk may cease to be entitled to depreciation allowances associated with the underlying asset since, in legal form, the asset has been transferred to the SPV during the term of the Sukuk

- The existing qualifying debt instrument (QDI) scheme does not cover Sukuk and the coupon payments and disposal gains derived from Sukuk cannot enjoy tax concession/exemption under the scheme even though the Sukuk can meet the relevant conditions.

Legislative proposals

The Hong Kong government proposes to adopt a prescriptive and religion-neutral approach similar to that adopted in common law jurisdictions such as the UK. The legislation will not make any specific reference to or mention of Shariah. This will provide more certainty to market players and prevent disputes arising from different interpretations of Shariah principles by Shariah scholars.

Initially, it is proposed to adopt a phased implementation covering the four more common Sukuk types - Ijarah, Musharakah, Mudarabah and Murabahah.

The majority of Sukuk in the global market involve tripartite structures, comprising an originator, an SPV (formed for the sole purpose of issuing Sukuk) and Sukuk-holders, and this structure is proposed to be used as the basis for the proposed legislative amendments.

A new Part, to provide for the new special tax regime for Sukuk and a new Schedule, will be introduced into the IRO and provide for:

- The essential features of the alternative bond scheme, bond arrangement and investment arrangement

- The specific features of the three specified investment arrangements

- The conditions to be met for a bond arrangement and an investment arrangement to qualify for special tax treatment

- The special tax treatment applicable to a qualified bond arrangement and a qualified investment arrangement

- The circumstances under which a qualified bond arrangement or a qualified investment arrangement will be disqualified

- The consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement

- Key miscellaneous amendments.

Similarly, a new Part will also be introduced into the SDO to provide for:

- The conditions and requirements to be met for an instrument executed in relation to a bond arrangement and an investment arrangement to qualify for stamp duty treatment/relief

- The stamp duty treatment/relief applicable to an instrument executed in relation to a qualified bond arrangement and a qualified investment arrangement that meets the conditions and requirements

- The obligations of the originator and bond-issuer after grant of the stamp duty relief

- The circumstances under which a qualified bond arrangement or a qualified investment arrangement will be disqualified

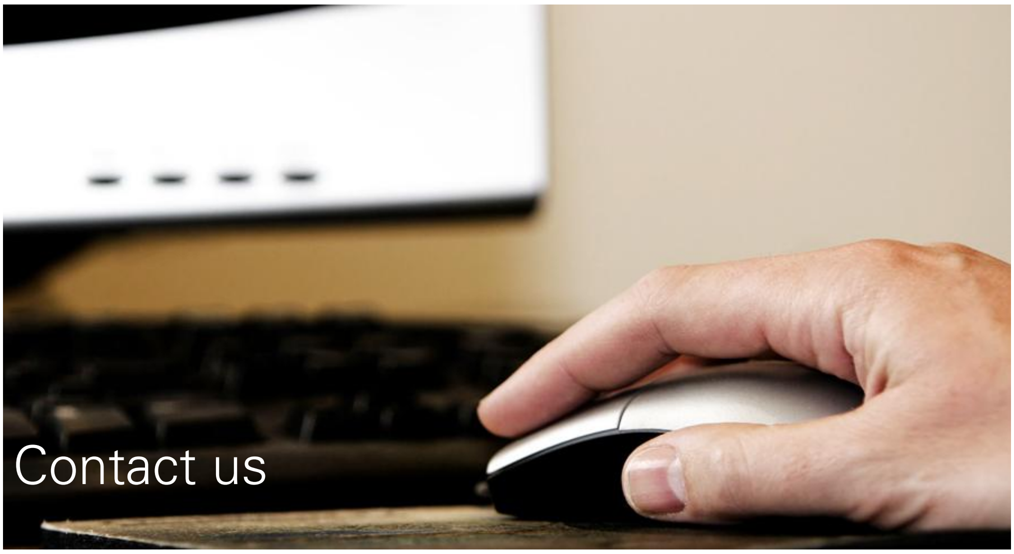
- The consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement

- Key miscellaneous amendments.

The IRD will provide further guidance in respect of the proposed tax regime for Sukuk when the relevant legislative amendments have been enacted.

Comment

This development has been a long time in gestation, but it is, nonetheless, welcome, as it will further enhance the status of Hong Kong as an international finance centre. The proposed legislative amendments put forward by the Hong Kong government will need to be critically assessed to ensure that they adequately address the requirements for Islamic finance to be viable in Hong Kong. KPMG is in the process of making a submission to the government on the consultation.



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