cutting through complexity

Tax alert

Issue 18 – November 2012

Government releases results of consultation on legislation for Islamic bonds (Sukuk)

On 29 October 2012, the Hong Kong government ('The Government') issued the consultation conclusions on proposed amendments to the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO) to provide a taxation framework that levels the playing field between Islamic bonds and conventional bonds.

Background

The Government launched a two month consultation in March 2012 on this proposal, which aims to promote the development of an Islamic bond market in Hong Kong (see Tax alert Issue 9 – April 2012).

Islamic finance is among the fastest growing segments in the international financial system. Globally speaking, Islamic finance assets have expanded from USD 150 billion in the mid-1990s to USD 1.3 trillion in 2011.

The Government is currently finalising a bill and aims to introduce it to the Legislative Council in early 2013.

Consultation conclusions

In the consultation, the Government proposed to cover four types of Sukuk viz. Ijarah, Musharakah, Mudarabah and Murabahah - however, it is considering the inclusion of Wakalah (agency arrangement), which is becoming increasingly popular in the global Sukuk market. The proposed legislation will prescribe the major features and characteristics of these product structures ('alternative bond schemes') and take a broader coverage than, for example, the relevant UK tax legislation, to cover both listed and unlisted Sukuk.

It has also been proposed that the Financial Secretary be empowered to amend certain parts of the tax laws by way of subsidiary legislation in the future in order to expand the scope of the proposed tax regime to respond to evolving market developments.

In response to submissions, the Government has indicated that it will further modify and clarify the original proposals set out in the consultation as follows:

(a) to relax the 'maximum term length' condition by changing the maximum term length requirement for qualified alternative bond schemes from 10 to 15 years

(b) to set out in clearer terms in Departmental Interpretation and Practice Notes (DIPNs) and Stamp Office Interpretation and Practice Notes (SOIPNs) the operation of the 'limit on return' condition so that the condition will only be invoked to target equity or equity-like Sukuk, which are not economically equivalent to conventional bonds

(c) to increase the flexibility of the 'connected with Hong Kong' condition by providing an alternative way to satisfy it. If a Sukuk issue is lodged with and cleared by the Central Moneymarkets Unit operated by the Monetary Authority, it will also satisfy the condition

(d) to reduce compliance costs and administrative burden on issuers by removing the 'diverse holding' requirement that not more than 50 percent of the alternative bonds under an alternative bond scheme be beneficially held by or are acquired with funds provided, directly or indirectly, by an originator, a bond issuer and their associated persons

(e) to relax the proposed record-keeping requirement imposed on a bond issuer or an originator. For the purposes of the IRO, relevant documents will be required to be kept for a period extended to '3 years (instead of 7) after the end of the Sukuk term' or '7 years after the relevant transaction', whichever is longer. For the purposes of the SDO, it is proposed to relax the record-keeping requirement to '1 year (instead of 7) after the end of the Sukuk term'

(f) to clarify in the SOIPNs that the proposed security arrangement for the purposes of a stamp duty determination and charge under the SDO will mean to accept, apart from an upfront cash security, a registered first legal charge on the leasehold property, a pledge of quoted shares or a bank guarantee.

Comment

The Government's initiative to introduce legislation to level the playing field between Islamic finance and conventional bonds is welcome. It is also pleasing that the Government has, and modified, its proposals to take into account of many of the representations made during the consultation and that it will be taking a flexible approach in responding to changes in the market environment.

Nevertheless, some areas of concern remain:

(a) While the Government's concerns over the risk of tax avoidance from the proposed changes are understandable, the consequences of a breach of the regime can be severe. We are pleased to note that amendments have been made to disregard some events outside the control of the relevant participants, such as legal restraints, cash flow problems and total loss. However, given the rapid and significant changes in accounting standards over the last 15 years, we do not share the Government's confidence that further significant changes are unlikely. Similarly, given the subjective nature of some of the tests (for example, what constitutes a commercial return), the significant cost of a breach of the regulations may act as a disincentive to some investors.

Comment cont.

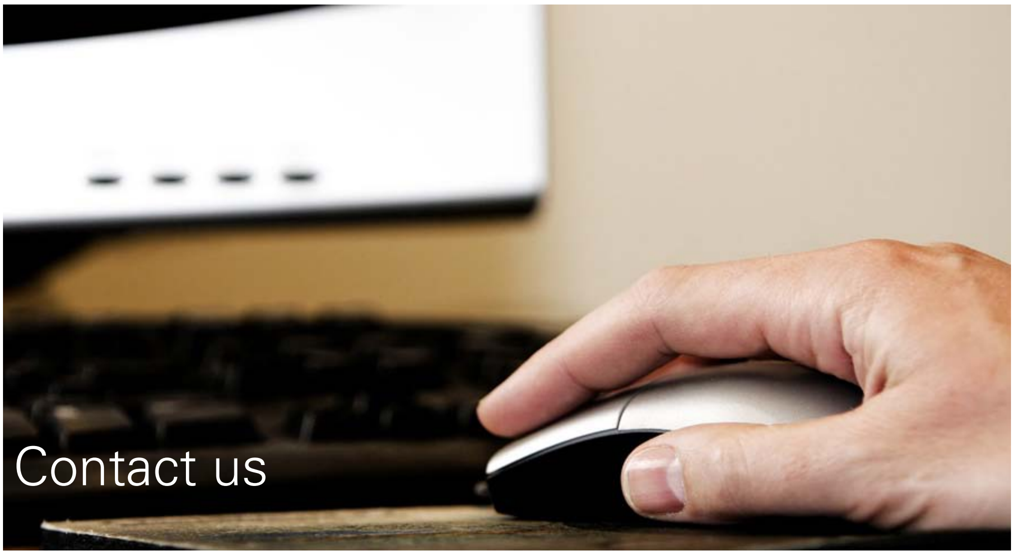
(b) Although we understand that the legislation surrounding Islamic bonds will be some of the most complex tax legislation introduced in Hong Kong, the proposals still leave a lot of the detail to be dealt with in DIPNs and SOIPNs. This has the potential to cause a conflict of interest for the IRD and Stamp Office, whose primary role is revenue collection rather than nurturing Hong Kong as a leading financial centre. Further, practice notes are not subject to the same degree of scrutiny as legislation, and, as a number of recent court cases have shown, they do not have the force of law. We would prefer to see all important aspects of the rules enshrined in legislation.

(c) The requirement for the participants to lodge security for stamp duty could be a significant issue. As the Government notes in its response, the amounts involved may be substantial and it is not clear what the timeframe for the release of such security would be. Depending on the form the security takes, this could involve tying up significant amounts of capital or the incurrence of guarantee fees for many years. It is an issue that will need to be considered carefully in the SOIPN.

(d) We understand that the extended time limits for assessments will apply only to additional assessments arising as a direct result of a disqualification from the Islamic financing regime. However, we do not see any clear statement of this approach in the latest proposal. We hope that the final legislation will make this clear.

(e) As a general comment, the steps the Government is taking go a long way towards levelling the field from a tax perspective, but concerns over avoidance mean that complete parity is unlikely to be achieved. We note that the non-tax costs of entering into Islamic financing arrangements are generally also higher than for conventional financing. The Malaysian government has sought to address some of these concerns by introducing compensating tax breaks. While we understand the reasons for not doing this in Hong Kong, the comparatively high costs of entering into such arrangements in Hong Kong may restrict the attractiveness of the market for some investors.

At this stage, many of the details are still to be finalised, and much will depend on the final guidance issued in the practice notes. It is encouraging that the Government has taken on board many of the comments raised during the consultation process, and provided they remain equally responsive as the further details of the proposals are ironed out, the Islamic financing arrangements should assist to consolidate Hong Kong's status as a leading international financial centre.



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