

HONG KONG TAX ALERT

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Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 introduced

The Bill, which was introduced in the Legislative Council on 9 January 2013, seeks to amend the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO) to place common types of Islamic bonds on a level playing field with conventional bonds and remove a perceived impediment to the development of a sukuk market in Hong Kong.

Background

The Bill delivers the policy initiative first articulated by the then 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. The proposal was also the subject of a public consultation in March 2012 – the results of which are reported in [Tax alert Issue 18 November 2012](#).

The prohibition on payment of interest and the transfer of assets involved, results in additional tax exposures for Islamic finance products when compared with an economically equivalent debt arrangement. The Bill seeks to remove these additional tax imposts.

The Bill

The Bill will not confer special tax concessions on the Islamic finance sector, but will ensure that financial instruments of similar economic substance are afforded similar tax treatment. In addition, the Bill will not make specific references to Shariah terminologies, and will adopt a religion-neutral approach using the term 'alternative bond scheme' (ABS), rather than Sukuk, to denote the arrangement to which the proposed tax treatment will apply.

The Bill specifies four types of investment arrangements, corresponding to the different underlying structures by which investment returns are generated in the five most common types of Sukuk in the global market. The types of investment arrangements specified in the Bill are:

- A lease arrangement (Ijarah) where a bond-issuer enters into a lease in respect of an acquired asset with an originator to generate an investment return
- A profit sharing arrangement (Musharakah and Mudarabah) where a bond-issuer enters into a business undertaking with an originator to carry on business activities to generate an investment return

- A purchase and sale arrangement (Murabahah) where a bond-issuer sells an acquired asset to an originator with a markup to generate an investment return
- An agency arrangement (Wakalah) where a bond-issuer appoints an originator as its agent to manage an acquired asset to generate an investment return.

The Bill also proposes to empower the Financial Secretary to expand the coverage of eligible ABS, by way of subsidiary legislation in future.

Qualifying conditions

For a bond arrangement in a specified ABS to be a 'qualified bond arrangement', it must satisfy certain qualifying conditions. The qualifying conditions are (i) the reasonable commercial return condition; (ii) the bond arrangement as financial liability condition; (iii) the Hong Kong connection condition; (iv) the maximum term length condition (maximum term of 15 years); and (v) the arrangements performed according to terms condition.

For a specified investment arrangement in a specified ABS to be a 'qualified investment arrangement' (i) the bond arrangement in the scheme must always be a qualified bond arrangement; and (ii) the scheme must always comply with the 'bond-issuer as a conduit' condition and the 'investment arrangement as financial liability' condition.

The proposed legislation seeks to ensure that a prospective ABS is economically equivalent to a conventional bond structure and eligible for the proposed tax treatment. The Bill also seeks to ensure that safeguards are in place to minimise tax avoidance and that the ABS has a nexus with Hong Kong, thereby promoting Hong Kong's financial market development.

Proposed tax treatment

The proposed legislation seeks to treat a qualified bond arrangement and a qualified investment arrangement under a specified ABS as 'debt arrangements' for the purposes of the IRO and SDO, and to apply comparable tax treatments accordingly.

Accordingly, bond proceeds paid by bond-holders to the bond-issuer will be regarded as money borrowed by the bond-issuer from the bond-holders, and the coupon payments payable by the bond-issuer to the bond-holders will be regarded as interest payable on such money borrowed. To this end, the Bill will modify specific provisions of the IRO and SDO. For instance, the tax concession and exemption for qualifying debt instruments under sections 14A and 26A of the IRO will apply to alternative bonds transferrable by their delivery issued under a qualified bond arrangement. Section 15(1)(j), (k) and (l) of the IRO (which treats any disposal gains before maturity and the premium/discount element received on maturity of certificates of deposits as trading receipts for profits tax purposes unless they fall within the qualifying debt instrument scheme to which section 14A applies) will be extended to alternative bonds under a qualified bond arrangement that are transferrable by their delivery.

With respect to a qualified investment arrangement, the acquisition cost of the assets will be regarded as the money borrowed by the originator from the bond-issuer. The investment return will be regarded as interest payable on the money borrowed by the originator from the bond-issuer.

When a bond arrangement disqualifying event or an investment arrangement disqualifying event occurs, an arrangement that was formerly a qualified bond arrangement will be regarded as never having been qualified. This may result in the withdrawal of any reliefs previously granted under the IRO and the SDO.

Record keeping, notifications, assessments and other miscellaneous matters

The Bill will provide for record-keeping, notifications, assessments and other miscellaneous matters to address tax avoidance concerns. The existing section 51C of the IRO will be modified and new provisions added to the SDO, to require persons granted tax relief in respect of a specified ABS to keep records for an extended period. They will be obliged to inform the Commissioner of Inland Revenue and the Collector of Stamp Revenue of any disqualifying event, which may lead to a withdrawal of the relief granted in its entirety under the IRO and SDO. The time limits for raising additional profits tax assessments/recovery of stamp duty will also be extended where a disqualifying event occurs.



Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR

Tel: +86 10 8508 7082
khoonming.ho@kpmg.com



Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR

Tel: +852 2826 7165
ayesha.lau@kpmg.com



Chris Abbiss
Partner

Tel: +852 2826 7226
chris.abbiss@kpmg.com



Darren Bowdern
Partner

Tel: +852 2826 7166
darren.bowdern@kpmg.com



Barbara Forrest
Principal

Tel: +852 2978 8941
barbara.forrest@kpmg.com



Daniel Hui
Principal

Tel: +852 2685 7815
daniel.hui@kpmg.com



Charles Kinsley
Principal

Tel: +852 2826 8070
charles.kinsley@kpmg.com



John Kondos
Partner

Tel: +852 2685 7457
john.kondos@kpmg.com



Alice Leung
Principal

Tel: +852 2143 8711
alice.leung@kpmg.com



Curtis Ng
Partner

Tel: +852 2143 8709
curtis.ng@kpmg.com



Kari Pahlman
Principal

Tel: +852 2143 8777
kari.pahlman@kpmg.com



John Timpany
Partner

Tel: +852 2143 8790
john.timpany@kpmg.com



Wade Wagatsuma
Partner

Tel: +852 2685 7806
wade.wagatsuma@kpmg.com



Jennifer Wong
Partner

Tel: +852 2978 8288
jennifer.wong@kpmg.com



Chris Xing
Partner

Tel: +852 2978 8965
christopher.xing@kpmg.com



Karmen Yeung
Partner

Tel: +852 2143 8753
karmen.yeung@kpmg.com



Kate Lai
Director

Tel: +852 2978 8942
kate.lai@kpmg.com



Alex Lau
Director

Tel: +852 2143 8597
alex.lau@kpmg.com



Benjamin Pong
Director

Tel: +852 2143 8525
benjamin.pong@kpmg.com



Garry Laird
Senior Tax Advisor

Tel: +852 2143 8795
garry.laird@kpmg.com

kpmg.com/cn

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