Inland Revenue Department issues guidance on Taxation of Specified Alternative Bond Schemes (Islamic Financing)

The Inland Revenue Department (IRD) has issued Departmental Interpretation and Practice Note No. 50 ("the DIPN") on the Taxation of Specified Alternative Bond Schemes. The DIPN gives the IRD's views on the correct interpretation of the legislation introduced last year to allow for greater tax parity between conventional and Islamic bond arrangements.

Background

The Legislative Council passed the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 ("the Ordinance") in July 2013. The Ordinance changed the tax rules applying to Islamic financing arrangements. It also introduced Schedule 17A of the Inland Revenue Ordinance ("the Schedule") to give effect to most of the changes. The Ordinance is unusual in that it deliberately leaves a number of important points to be clarified in practice notes issued by the IRD and the Stamp Office. The DIPN covers only direct taxes – stamp duty will be addressed in a separate Stamp Office practice note to be issued shortly.

Overview

The DIPN is fairly lengthy at 48 pages plus an appendix, and provides the IRD's commentary on how the new legislation works, together with some examples. Broadly, the legislation attempts to remove some of the tax inefficiencies that previously applied to Islamic financing arrangements, under which the use of interest is banned. Under the legislation, provided that a number of conditions are met, bond arrangements that in legal form are agreements for a lease, and a sharing of profits or a purchase and sale can be regarded as debt arrangements for tax purposes.

Under Islamic law, it is forbidden to charge interest. Consequently, financing must be obtained in a different way from a conventional loan and a number of different approaches exist. For example, an asset may be sold to a financer and leased back over a number of years before being returned to the original owner at the end of the lease period. The cash flows are economically similar to those under a conventional mortgage arrangement, but without specific legislation, the arrangement can be very inefficient from a tax perspective. This is because each asset transfer might attract stamp duty, capital allowances would fall due to the financer rather than the operator, and profits and/or property tax liabilities might arise on the financing return.

Other arrangements may take the form of a profit share, but distributions of profit are not typically deductible whereas payments of interest often are. The legislation aims, as far as possible, to ignore the tax consequences that would normally arise from the legal form of these transactions and to tax them on the same basis as interest on a conventional loan.

Most of the legislation and the DIPN are concerned with the conditions of qualification. These are complicated and strive to strike a balance between creating a regime which is flexible enough to encourage the growth of Islamic bonds, while imposing sufficient controls to prevent tax avoidance.

Specific clarifications

Following the consultation process in 2012, the Financial Services and the Treasury Bureau (FSTB) responded to a number of the opinions given by stating their views and saying that these would be reflected in a DIPN (rather than being included in the Ordinance). The DIPN therefore provides the IRD's response to a number of the assurances given in response to the consultation exercise but not reflected in the Ordinance as enacted. These include:

Inadvertent breaches

A number of concerns were raised in the consultation process about the risk of falling outside the special regime as a result of inadvertent breaches of the rules. The rules are fairly prescriptive, and any breach could result in the entire bond retrospectively being taxed under the conventional rules. A number of potential inadvertent breaches were raised in the consultation process. For example, continuing qualification is dependent on the arrangement being classified as a debt under International Financial Reporting Standards (IFRS) and on the return being at a reasonable market rate. Further, it may be necessary to extend the term of the arrangement as a result of legal difficulties with transferring the asset or cash flow problems that the originator may have.

In the responses to these concerns, the FSTB announced that the Commissioner of Inland Revenue ("the Commissioner") would explain in a DIPN that any delay as a result of legal constraints, cash flow problems or insolvency on the part of the originator causing delayed payments or non-disposal of the specified assets will be disregarded, and that any total loss of the specified asset resulting in early termination of the bond arrangement will not amount to a breach of features and conditions. It is noticeable that in the DIPN, these assurances have been watered down from "will not" to "may not". The flexibility is limited to unforeseen delays – other inadvertent breaches are still likely to lead to disqualification, and the IRD also makes it clear that the bond cannot under any circumstances exceed 15 years, even if there is a reasonable excuse for the delay.

Reasonable commercial return

The DIPN contains a number of comments on how the reasonable commercial return condition will be applied. The IRD acknowledges that, in general, alternative bonds will carry a higher risk than conventional bonds. It also acknowledges that a reasonable commercial return may vary within a range.

The IRD's main concerns are to attack returns:

- That are not subject to an upper limit
- That are linked to profits; or
- For which the margin is blatantly above what would be reasonable and commercial for a similar debt security.

In other words, although the legal form of the arrangement may indicate that the financer is participating in the profits of an enterprise, the return should look more like a conventional interest return. While this does not necessarily need to be a simple fixed or variable rate, the IRD is concerned that conventional business enterprises should not be able to take advantage of the revised tax rules. The IRD has indicated that it will generally accept benchmarking to similar bonds on similar terms.

Agents and management activities

The legislation requires that the bond issuer arrange the management of the specified asset over the term of the bond.

The DIPN clarifies that the bond issuer is not required to undertake the management itself and may appoint an agent, including the originator. The DIPN explains that where necessary, the bond issuer can employ a wide range of agents to administer the property. The DIPN notes that in lease and profit sharing arrangements, management activities are often documented in the relevant agreements, but it is left vague as to whether the Commissioner considers this to be essential.

Advance rulings

The DIPN sets out the procedures for applying for an advance ruling. While the ability to obtain an advance ruling is useful in providing greater clarity, we note the statement that the Commissioner will require maximum disclosure and that an extended response period of eight weeks is set out. This may result in increased cost, both financial and in terms of time, compared to conventional arrangements, which goes against the spirit of the legislation in attempting to level the playing field. We would hope that once the IRD has established greater familiarity with these products, simplified procedures might be introduced for the more common arrangements.

General comments

For the most part, the DIPN follows the legislation fairly closely and does not offer much additional material. In some ways this is a good thing. We have previously expressed concern about the process of legislating on a broad level and leaving the details to be filled in with DIPNs. The process risks confusing the role of the tax collecting authority with those parts of government charged with financial policy and reducing the amount of scrutiny over legislation. Further, as the DIPN is expressly stated to be non-binding, it is unclear what authority the provisions have where the government has clearly stated an intention for the Commissioner to set out policy. On the other hand, while the DIPN contains some useful clarifications, it perhaps leaves a degree of subjectivity in many of the arrangements that may not be desirable to taxpayers.

The DIPN can be accessed here.

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