



15 June 2012

By email (sukuk_consultation@fstb.gov.hk) and by hand

Our Ref.: C/TXG, M83786

Miss Salina Yan, JP
Deputy Secretary for Financial Services and the Treasury (Financial Services) 1
Financial Services and the Treasury Bureau,
24/F, Central Government Offices
2 Tim Mei Avenue
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Hong Kong

Dear Miss Yan,

[Consultation on the proposed amendments to the Inland Revenue Ordinance and the Stamp Duty Ordinance to facilitate development of a sukuk market in Hong Kong](#)

Thank you for inviting views from the Hong Kong Institute of CPAs (Institute) on the proposed amendments to the Inland Revenue Ordinance (IRO) and the Stamp Duty Ordinance (SDO) to facilitate development of a sukuk market in Hong Kong. We note that the proposed legislative amendments are aimed at creating a level playing field between four common types of sukuk and conventional bonds.

The Institute welcomes the initiative to introduce legislation to encourage the development of Islamic finance in Hong Kong and we support the adoption of a religion-neutral approach in the legislation, as has been adopted in the United Kingdom (UK) and other jurisdictions.

Lease back arrangement

In the proposal at 3.4, one of the specific features for a leaseback arrangement is that the assets should be purchased from the bond-issuer by the originator at the end of the sukuk term.

The Institute would like to clarify what would happen were the originator to be unable to complete the repurchase in particular circumstances, for example, due to insolvency of the originator. In such circumstances, would the arrangement be disqualified as a specified investment arrangement, thus triggering retroactive withdrawal of the special tax treatment? This would seem unfair. (See also our comments below on circumstances for disqualification.)

We also note that the bond-issuer will potentially have a lease over Hong Kong immovable property and, as such, fall within the charge to Hong Kong property tax. While the proposals at 3.16.4 and 3.17.4 state that bond-holders and bond-issuers are to be regarded as not having any legal or beneficial interest in the specified asset under the specified alternative bond scheme, we suggest that it be



made clear that this would apply for the purposes of section 5 of IRO. The Institute recommends that both the bond-issuer and the bond-holders are exempted from property tax in respect of any transactions arising under the alternative bond arrangements.

"Limit on return" condition

The proposal at 3.14.5 states that the maximum total amount payable and the total amount paid in each period must not exceed an amount that would be a reasonable commercial return on money borrowed of the amount of the bond proceeds.

A reasonable commercial return for a sukuk is determined by many factors such as fixed or floating rate, loan amount, risk level, currency, credit-rating of the originator and volatility of the value of the underlying asset. With such a variety of factors, it would be desirable for the process to be used to determine the reasonable commercial return in any given circumstances to be made clear at the outset.

We note that the return on the sukuk needs to be economically equivalent to conventional debt arrangement (proposal at 3.14.6). The Institute would like to know, therefore, if the Inland Revenue Department (IRD) would, like the UK tax authority, recognise that the return on a sukuk is likely to be higher than its conventional counterpart, commensurate with the higher risk for sukuk holders, who may have recourse only to the underlying bond assets and not be able to sue for the debt.

The Institute questions whether the condition to check payments within each individual period during the term is necessary. Given the condition to account for the sukuk as a financial liability, which ensures that it is, in substance, a debt (proposal at 3.14.7), and provided that payments are made within the specified term, the payment pattern should not matter.

'Maximum term length' condition

The proposal at 3.14.9 states the maximum term length should not be longer than ten years. We would suggest that discretion be given to IRD to accept applications for a scheme with a term longer than ten years. While most sukuk in the market have a tenor of ten years or below, some may extend beyond ten years. If the arrangements meet the other requisite conditions for a special tax treatment, we believe that they should be considered on a case-by-case basis, by continuing the existing mechanism under section 87 of the Inland Revenue Ordinance, or through the advance ruling procedure.

Qualified investment arrangement

The proposal at 3.17.3 states that investment return is to be regarded as interest payable on money borrowed by the originator from the bond-issuer. Where the investment return is regarded as interest income earned by the bond-issuer, against which interest payment to bond-holder could be deducted, it is unclear how the source of such interest income would be determined. For example, would the



bond-issuer be treated as carrying on a money-lending business such that the operations test will apply, or would it be based on the provision of credit test. As far as possible, this should be made clear in legislation. Details could be contained in subsidiary legislation.

Record keeping

The Institute notes that the proposed record-keeping and return-furnishing requirements (proposals at 3.20.1 and 3.43.1) are much more stringent than for conventional bonds, which is not consistent with the principle of creating a level playing field.

The record-keeping requirement seems excessively onerous. In the case of a sukuk with a ten-year term, the rule appears to require the records relating to the origination of the sukuk to be maintained for 17 years.

Circumstances for disqualification

The proposals in the consultation document are that, if at any time, a qualified bond or investment arrangement fails to meet the requisite conditions and is disqualified, it will be treated as never having been a qualified arrangement (proposals at 3.21 and 3.23). We consider this retroactive withdrawal of the special tax treatment to be punitive. We understand that it is not present within the UK legislation on which these proposed legislative amendments are based.

We would recommend that, upon a disqualifying event, the qualified arrangement, as appropriate, should retain its special tax treatment up to and including the year of assessment preceding the disqualifying event. This is because up to the disqualifying point, the sukuk arrangement would be economically equivalent to a conventional bond and as such should be entitled to the special tax treatment for that period. This is consistent with the objective of levelling the playing field. It would also alleviate any perceived need to extend the time limits for making assessments and record-keeping. (See also our comments on record-keeping and consequences of disqualification.)

We note, however, that this would require the introduction of transitional provisions to deal with the change from special tax treatment back to taxation on general principles, which, we believe should be able to be addressed. For example, where a qualified investment arrangement, being a leaseback arrangement, is disqualified before the end of the specified term, the bond-issuer, as owner of the underlying asset will then be entitled to claim depreciation allowances, whereas previously the originator was deemed to own the assets and was entitled to claim depreciation allowances. In this scenario, the transitional provisions could provide that the previous deeming provisions would cease to operate and the bond-issuer would be entitled to claim depreciation allowances on an appropriate basis.

Consequences of disqualification

A further concern is the proposal to amend section 60(2) of the IRO, where a qualified bond or investment arrangement becomes disqualified, the six-year



period currently specified in which to raise an additional assessment would begin to run only after the expiration of the year of disqualification, instead of after the expiration of the specified year of assessment (see proposal at 3.28). Therefore, this would draw a distinction between conventional bonds and qualified bond arrangements and again run counter to the objective of creating a level playing field. A similar proposal applies in the case of stamp duty in the proposal at 3.49.

We also note that in the UK legislation, the time bar provisions are not extended where disqualification occurs.

We recommend that this proposal be dropped because the arrangement may be adequately scrutinised in the first six years to ensure compliance, given the nature of the sukuk structure, which documents its financial flows at the commencement of the arrangement.

Furthermore, the anti-avoidance under section 61A of the IRO could be used to combat any tax avoidance arrangement, for example, deliberately delaying the disqualifying event until the end of the term.

Stamp duty

Under the proposal at 3.38, security to the satisfaction of the Collector of Stamp Revenue must be given in respect of the amount of stamp duty which would be covered by the relief. We should like to clarify that the exemption currently available under section 45(2) of the SDO would also apply to a bond-issuer and an originator that are associated, that is, no additional security would be required.

Clarification in practice notes

We note that many of the issues outlined in the consultation paper will be clarified in a Departmental Interpretation and Practice Note and Stamp Office Interpretation and Practice Note, which the IRD will issue subsequent to the enactment of the relevant legislation.

It would not be desirable for a number of uncertainties in the proposed legislation to be left to interpretation in practice notes. Rather, the legislation, be it primary or subsidiary legislation, should be sufficiently clear and comprehensive to minimise the need for further interpretation and clarification in practice notes.

Other matters

Provisions to deal with sukuk address the treatment of certain structures that may be established under a sukuk ("investment arrangement"). However, these provisions to clarify the treatment of such underlying structures apply only in the context of sukuk. We suggest further consideration be given to affording such structures the same treatment, even where no sukuk is involved. If, for example, an Islamic bank sought to advance funding to a company in Hong Kong directly using one of these arrangements, it would seem sensible for the same tax treatment to apply, as if the advance of funds were from the bond-issuer under a sukuk structure. Having done the work of defining such arrangements for the purposes of



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dealing with the treatment of sukuk, it would seem to be a straightforward and logical step to allow for the same treatment to be applied in other appropriate situations, as described above.

Should you have any questions on the Institute's submission, please contact me on 22877084 or at peter@hkiipa.org.hk.

Yours sincerely

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PMT/EC/sc



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