Proposed Amendments to the Inland Revenue Ordinance (Cap. 112) and the Stamp Duty Ordinance (Cap. 117) to Facilitate Development of an Islamic Bond (i.e. Sukuk) Market in Hong Kong

Consultation Paper

Financial Services and the Treasury Bureau
www.fstb.gov.hk

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FOREWORD

1. This paper is issued by the Financial Services and the Treasury Bureau ("FSTB") to consult the market on the proposed amendments to the Inland Revenue Ordinance ("IRO") (Cap. 112) and the Stamp Duty Ordinance ("SDO") (Cap. 117) with a view to facilitating development of an Islamic bond (i.e. sukuk) market in Hong Kong.

2. FSTB welcomes written comments from market participants and other stakeholders on or before 28 May 2012 through any of the following means –

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3. FSTB may, as appropriate, reproduce, quote, summarise and publish the written comments received, in whole or in part, in any form and use without seeking permission of the contributing parties.

4. Names of the contributing parties and their affiliation(s) may be referred to in other documents we publish and disseminate through different means after the consultation. If any contributing parties do not wish their names and/or affiliations to be disclosed, please expressly state so in their written comments. Any personal data provided will only be used by FSTB, or other government departments/agencies for purposes directly related to this consultation.

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ABBREVIATIONS

BA	Bond Arrangement
CIR	Commissioner of Inland Revenue
CSR	Collector of Stamp Revenue
DIPNs	Departmental Interpretation and Practice Notes
FS	Financial Secretary
FSTB	Financial Services and the Treasury Bureau
IA	Investment Arrangement
IFC	International Financial Centre
IRD	Inland Revenue Department
IRO	Inland Revenue Ordinance (Cap. 112)
LegCo	Legislative Council
QDI	Qualifying Debt Instrument
SDO	Stamp Duty Ordinance (Cap. 117)
SOIPNs	Stamp Office Interpretation and Practice Notes
SPV	Special Purpose Vehicle
UK	United Kingdom

EXECUTIVE SUMMARY[1]

1. It has been the Government's policy initiative to develop Islamic finance in Hong Kong with a view to diversifying our financial platform and consolidating our status as an international financial centre ("IFC").

2. As a first step, our focus is to promote the development of a sukuk market in Hong Kong. However, as the payment and receipt of interest is prohibited under Shariah, the issuance of sukuk often involves more complex structures which may give rise to additional tax and stamp duty implications and uncertainty under our existing tax laws, thereby putting sukuk at a disadvantage as compared with their conventional counterparts.

3. We therefore consider it necessary to align the tax and stamp duty treatment of common types of sukuk with that applicable to their conventional counterparts by making necessary amendments to the Inland Revenue Ordinance ("IRO") and the Stamp Duty Ordinance ("SDO").

4. In formulating the legislative proposals, we have taken into account developments in other IFCs and earlier feedback from major market players.

5. Under the legislative proposals, we propose to adopt a prescriptive and religion-neutral approach, in line with that adopted by other major financial markets such as the United Kingdom ("UK"), as prescriptive legislative provisions without specific reference to Shariah principles would provide more certainty in implementation to market players in Hong Kong.

6. We propose to cover four types of sukuk, viz. Ijarah, Musharakah, Mudarabah and Murabahah, which are the relatively more common types of sukuk in the global market.

[1] The Chinese translation of this Executive Summary is available on FSTB's website.

7. We also propose to adopt a tripartite structure, comprising an originator, a bond-issuer and bond-holders, as the basis for the framework of the proposed legislative amendments. Specifically, we propose to introduce a new term known as **alternative bond scheme** containing two arrangements, namely, **bond arrangement** and **investment arrangement**. The former refers to the arrangement between the bond-issuer and the bond-holders, while the latter refers to the arrangement between the bond-issuer and the originator.

8. We propose that under each of the aforesaid arrangements, a set of essential features and qualifying conditions must be satisfied in order for the parties involved to enjoy the special tax treatment and stamp duty treatment / relief applicable to that arrangement. However, under specified circumstances, the special tax treatment or stamp duty treatment / relief applied to the arrangement in question may cease to apply or be withdrawn by the Commissioner of Inland Revenue ("CIR") or the Collector of Stamp Revenue ("CSR") (as the case may be).

9. To allow the proposed special tax regime for sukuk to keep pace with market development in a more timely manner, we propose to empower the Financial Secretary ("FS") to amend certain parts of the legislation by subsidiary legislation, which will be subject to negative vetting by the Legislative Council ("LegCo"), to extend the special tax regime to additional types of sukuk.

10. To facilitate compliance, the Inland Revenue Department ("IRD") will provide guidance in respect of the key legislative provisions upon enactment in its Departmental Interpretation and Practice Notes ("DIPNs") and Stamp Office Interpretation and Practice Notes ("SOIPNs") as appropriate.

11. The proposed special tax regime for sukuk will represent an important step forward in facilitating the development of a sukuk market in Hong Kong. We will finalise the legislative amendments after carefully considering comments received on the legislative proposals set out in this consultation document.

Subject to market feedback, our plan is to introduce the relevant amendment bill into LegCo in the 2012-13 legislative session.

CHAPTER 1

INTRODUCTION

1.1 This chapter sets out the background and rationale for the legislative exercise.

Background

1.2 Generally speaking, Islamic finance refers to financial activities that are in compliance with the requirements, restrictions and prohibitions imposed by Islamic law (i.e. Shariah)[2], which is a religious concept. Growing into a global business of an estimated US$700 billion to US$1 trillion in recent years, Islamic finance has been gaining recognition among both Muslim and non-Muslim community, and has become part of the mainstream financial services industry. Major financial markets, like the UK, Singapore, Japan, Australia and Ireland, have been pressing ahead with the development of Islamic finance in their jurisdictions. Notwithstanding the global financial tsunami in 2008, the Dubai World crisis in 2009 and the Middle East turmoil in 2011, the market remains generally optimistic about the long-term prospects for the Islamic financial industry.

1.3 The policy initiative of developing Islamic finance was first articulated by the Chief Executive of the Hong Kong Special Administrative Region in his policy address in 2007, which highlighted the potential of introducing Islamic finance and encouraged the development of a sukuk market in the city. As we see it, Hong Kong, being an IFC, should seek to provide a full suite of financial products to market participants around the world. Developing Islamic finance will certainly help diversify Hong Kong's financial platform and add to the breadth and depth of our

[2] Shariah provides guidance or principal rules governing all aspects of the day-to-day activities of Muslims, including religion, politics, finance, business and family. The most relevant Shariah principles for the financial services industry are the prohibition on interest *(riba)* and excessive uncertainty *(gharar)*.

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 IFC.

1.4 Our existing strengths in the financial services industry can serve as a solid foundation for the development of Islamic finance here. For many years, Hong Kong has been serving as a centre for international financial intermediation, matching investors and fund-raisers from different parts of the world. As a free and open economy, Hong Kong has also developed a highly liquid capital market with a large presence of international financial intermediaries, a well-established market infrastructure, a sound legal system, a transparent regulatory framework and a simple tax regime.

1.5 Our role as China's Global Financial Centre also offers a unique advantage to Hong Kong in developing Islamic finance. Specifically, with the gradual liberalisation of the Mainland's financial market, Hong Kong can provide an ideal platform for Islamic investors in the Middle East to tap the tremendous investment opportunities in Mainland China, especially given the fact that half of our stock market capitalisation is Mainland-related and more and more Renminbi-denominated investment products are launched here. At the same time, Hong Kong can provide a premier platform for fund-raisers in the Middle East to tap the vast savings of Mainland investors. We therefore see the potential for Hong Kong to develop and promote Renminbi-denominated Islamic products to bridge the gap between the Mainland and the Middle East.

1.6 As a first step in promoting the development of Islamic finance in Hong Kong, our focus is to promote the development of a sukuk market here having regard to market needs and views.

Existing Taxation Framework in respect of Sukuk

1.7 Generally speaking, sukuk refer to investment certificates

economically equivalent to conventional bonds. However, since the payment of interest *(riba)* is prohibited under Shariah, unlike conventional bonds which are debt-based instruments that pay interest, 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. Issuance of sukuk therefore typically involves more complex structures such as setting up of 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 complex structures may attract additional profits / property tax implications and stamp duty charges, putting sukuk issuance at a disadvantage when compared with their conventional counterparts. Thus, the existing tax regime is considered to be a major impediment to developing a sukuk market in Hong Kong.

1.8 According to our in-house studies as well as feedback from major market players, key tax issues involved in sukuk issuance are as follows –

(a) if the underlying asset involved 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;

(b) unlike conventional bonds, the coupon payments made by the SPV to sukuk-holders and certain periodic payments from the originator to the SPV are not deductible from profits for tax purposes as they are not interest payments in legal form;

(c) in contrast with conventional bonds, the originator of the sukuk may no longer be entitled to depreciation allowances associated with the underlying asset since, in legal form, the asset has been transferred to the SPV during the sukuk term; and

(d) since the existing qualifying debt instrument ("QDI") scheme does not cover sukuk, 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.

The tax issues above are illustrated in a set of diagrams based on an Ijarah sukuk structure at **Annex 1**.

1.9 Under the existing tax framework, market players in fact can make use of the administrative mechanism available under section 87 of IRO and section 52 of SDO to apply for tax exemption and stamp duty remission respectively in relation to sukuk issuance. Applications are considered on a case-by-case basis. In November 2009, we issued a package of reference materials, setting out the procedures involved, to facilitate market players in preparing applications for the aforesaid exemption and remission under the administrative mechanism.

Objective of the Legislative Exercise

1.10 Notwithstanding the administrative efforts, we consider it necessary to amend our tax laws to provide more transparency, certainty and clarity to the market. The overriding objective of the legislative exercise is to level the playing field for the more common types of sukuk vis-à-vis their conventional counterparts as far as profits tax, property tax and stamp duty liabilities are concerned. In other words, no additional advantages or incentives will be given to sukuk over and above those available to conventional bonds. Through removing undue tax obstacles and hence making sukuk issuance commercially viable, this legislative exercise would be conducive to promoting the development of a sukuk market in Hong Kong.

CHAPTER 2

OVERVIEW OF THE LEGISLATIVE PROPOSALS

2.1 This chapter sets out the key features of the legislative proposals, which have been devised after taking into account the latest developments in major overseas jurisdictions and earlier feedback from major market players.

Key Features of the Legislative Proposals

Approach - Prescriptive

2.2 We propose to adopt a prescriptive and religion-neutral approach similar to that adopted in the UK, which is also a common law jurisdiction. Under this approach, there will not be any specific reference to or mentioning of Shariah in the legislation. The advantage of this approach is that more certainty can be provided to market players, as prescriptive legislative provisions, without mentioning Shariah, would avoid incorporating religious concepts into our tax laws. This would help prevent any possible disputes arising from different interpretations of the Shariah principles by Shariah scholars in the context of implementing the relevant provisions, particularly given the fact that there is not yet a standardised approach to Shariah compliance around the world. In addition, this approach would also avoid the possible issue of discrimination, religious or otherwise.

Scope - Four Sukuk Types

2.3 Given the wide range of sukuk types in the global market and the fast pace of financial innovation, it is virtually impossible to cover all types of sukuk in our legislative proposals in one go. Having regard to overseas practices, in-house studies and market needs, we propose to adopt a phased implementation approach by covering

the four relatively more common sukuk types, viz. Ijarah[3], Musharakah[4], Mudarabah[5] and Murabahah[6], as the first step. These four sukuk types collectively represented almost 80% of global sukuk issuances in 2011[7], which should provide a reasonable starting point for the sukuk market to grow in the city. Under our proposal, both listed and unlisted sukuk, so long as falling within one of these four sukuk types, are intended to be covered in our regime. We will keep under review the scope of this regime and consider the need for introducing more sukuk types in the future having regard to local and international market development and experience.

Framework of Proposed Legislative Amendments

2.4 In view of the fact that the majority of sukuk in the global market involve a tripartite structure, comprising an originator, an SPV (which is formed for the sole purpose of issuing sukuk) and sukuk-holders, we propose to use this structure as the basis for the framework of our proposed legislative amendments. While in some cases, sukuk could be issued directly by the originator without having an SPV in the middle or there will be an extra SPV between the originator and the issuing SPV to distance further the parties, these kinds of structures are not commonly seen in the global sukuk market. Where appropriate, we will consider how to deal with these two kinds of structures in the future, having regard to local and international market development and experience.

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[3] Ijarah sukuk are based on a leasing structure, under which an asset is bought by one party from another party and leased back at a pre-agreed rental for a pre-determined lease period to the latter party who undertakes to buy back the asset at the end of the lease period. Ijarah is one of the most commonly used sukuk structures in the global sukuk market due to its simplicity.

[4] Musharakah sukuk are based on a partnership structure, under which two parties agree that each of them contributes to the capital of the partnership either in the form of cash or in kind. Both partners or one of them may manage the venture or alternatively both may appoint a third party to manage the venture. Any profits derived from the venture will be distributed based on a pre-agreed profit sharing ratio, while any loss will be shared in proportion to their initial capital investment.

[5] Mudarabah sukuk are based on another form of partnership structure, under which one party provides capital (the Rab al-Maal) and the other party provides managerial skills and acts as an entrepreneur who solely manages the project (the Mudarib). If the venture is profitable, the profits will be distributed based on a pre-agreed profit sharing ratio. In the event of a loss, it will be borne solely by the provider of the capital.

[6] Murabahah sukuk are based on a mark-up concept. It involves purchase of an asset from a third party for on-selling to another party at a mark-up price whereby the cost and the mark-up are made known and pre-agreed by all parties involved.

[7] According to statistics from Zawya Sukuk Monitor.

2.5 To reflect the tripartite structure of sukuk, we propose to introduce a term known as **alternative bond scheme** that contains two arrangements, viz. **bond arrangement** and **investment arrangement** respectively. There will be three specified parties in the alternative bond scheme, namely, the **originator**, **bond-issuer** and **bond-holders**.

2.6 A bond arrangement is an arrangement between the bond-issuer and the bond-holders that can meet certain features, while an investment arrangement is an arrangement between the bond-issuer and the originator containing certain general features. The investment arrangement essentially represents the underlying structure of sukuk. Given the wide variety of sukuk structures in the market, we propose to specify in the legislation several types of investment arrangement according to their specific features, each of which is known as a **specified investment arrangement**. As a start, there are three specified investment arrangements under our proposal, viz. leaseback arrangement (covering mainly Ijarah sukuk structure), profits sharing arrangement (covering business-plan Musharakah and Mudarabah sukuk structures), and purchase and sale arrangement (covering Murabahah sukuk structure).

2.7 An alternative bond scheme which contains a bond arrangement and a specified investment arrangement is known as a **specified alternative bond scheme**. If certain qualifying conditions are met, the bond arrangement in the specified alternative bond scheme will become a **qualified bond arrangement** and hence eligible for special tax treatment under IRO and certain stamp duty treatment under SDO. If certain additional qualifying conditions are also met, the investment arrangement in the specified alternative bond scheme will become a **qualified investment arrangement** and hence eligible for special tax treatment under IRO and certain stamp duty relief under SDO.

2.8 Under specified circumstances, however, the previously qualified bond arrangement will be disqualified and the relevant special tax treatment and stamp duty treatment will respectively be withdrawn

by the CIR and cease to apply to the bond arrangement. Similarly, under specified circumstances, the previously qualified investment arrangement will also be disqualified and the relevant special tax treatment and stamp duty relief will be withdrawn by the CIR and CSR respectively. The proposed framework above is illustrated in a diagram at **Annex 2**.

Structure of Proposed Legislative Amendments

2.9 Under IRO, we propose to create a new Part in the main legislation to provide for the applicability of the new special tax regime for sukuk, and a new Schedule to provide for, among other things –

(a) essential features of alternative bond scheme, bond arrangement and investment arrangement;

(b) specific features of the three specified investment arrangements;

(c) conditions to be met for a bond arrangement and an investment arrangement to qualify for special tax treatment;

(d) special tax treatment applicable to a qualified bond arrangement and a qualified investment arrangement;

(e) obligations of the originator and bond-issuer after the special tax treatment has been applied;

(f) circumstances under which a qualified bond arrangement or a qualified investment arrangement will be disqualified;

(g) consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement; and

(h) key miscellaneous amendments.

2.10 Under SDO, we propose to create a new Part in the main legislation to provide for, among other things –

(a) 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;

(b) stamp duty treatment / relief applicable to an instrument executed in relation to a qualified bond arrangement and a qualified investment arrangement that can meet the

conditions and requirements;

(c) obligations of the originator and bond-issuer after the stamp duty relief has been granted;

(d) circumstances under which a qualified bond arrangement or a qualified investment arrangement will be disqualified;

(e) consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement; and

(f) key miscellaneous amendments.

2.11 We recognise the need for market players to be clear about the proposed amendments to IRO and SDO. Therefore, IRD will provide further guidance in respect of the proposed special tax regime for sukuk in its DIPNs and SOIPNs upon enactment of the relevant legislative amendments.

CHAPTER 3

DETAILS OF THE MAJOR PROPOSED AMENDMENTS TO IRO AND SDO

3.1 This chapter sets out in more detail the major proposed amendments to the relevant parts and provisions of IRO and SDO. In formulating the detailed proposed amendments, we have taken into account the relevant legislation in major overseas jurisdictions, including the UK, Ireland, Australia, Singapore, etc., and the feedback obtained from major market players previously. It should be noted that this chapter is intended to explain the major proposed amendments while the actual legislative amendments will be finalised after taking into account comments received from market participants and other stakeholders during this consultation exercise.

PART I: DETAILS OF THE MAJOR PROPOSED AMENDMENTS TO IRO

A. Essential features of alternative bond scheme, bond arrangement and investment arrangement

3.2 We propose that an alternative bond scheme, and the two arrangements in it, viz. a bond arrangement and an investment arrangement, must contain certain essential features along the following lines –

3.2.1 The alternative bond scheme specifies a period (**specified term**) which commences on the date on which alternative bonds are issued, as referred to in paragraph 3.2.5 below, and at the end of which the scheme and arrangements in it cease to have effect;
[Remarks: Specified term essentially represents sukuk term. It is a common feature for those sukuk which are in

economic substance equivalent to debt instruments to have a fixed tenor.]

3.2.2 The bond arrangement provides for one or more persons (each such person is referred to as **initial bond-holder**) to pay a sum of money (**bond proceeds**) to another person (**bond-issuer**), the latter being an entity incorporated, constituted or acquired solely for the purposes of the alternative bond scheme;

[Remarks: This provides that the two parties involved in the bond arrangement are the bond-issuer and bond-holders.]

3.2.3 On behalf of the initial bond-holders, the bond-issuer enters with another person (**originator**) into the investment arrangement;

[Remarks: This provides that the two parties involved in the investment arrangement are the bond-issuer and originator. In essence, the investment arrangement is the underlying structure of the alternative bond issued under the bond arrangement.]

3.2.4 Under the investment arrangement, the bond-issuer uses the whole of the bond proceeds (**acquisition cost**) for acquiring an asset[8] (**specified asset**) to be held under the alternative bond scheme. Using the whole of the bond proceeds does not exclude using those proceeds for defraying legal fees, procuration fees, stamp duties and other expenses incidental to the issue of alternative bonds under the alternative bond scheme;

[Remarks: This provides that asset must be featured in the underlying structure of an alternative bond scheme, which is one of the key differences from conventional bonds. Acquisition of an asset may refer to acquisition of both the legal title and beneficial interest, or only the beneficial

[8] Asset is proposed to be defined as any property or any class of property. Property is defined in section 3 of the Interpretation and General Clauses Ordinance (Cap. 1) as including:

(a) money, goods, choses in action and land; and

(b) obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incident to property as defined in paragraph (a).

interest, of a single asset or a class of assets. The asset may be acquired from the originator (like Ijarah sukuk) or a third party (like Murabahah sukuk). The proposed requirement of using the whole of the bond proceeds is to ensure that the bond proceeds raised will not be used for purposes other than participating in the investment arrangement. That said, using a small part of the bond proceeds for defraying necessary expenses in connection with the issuance of the alternative bonds, i.e. sukuk certificates, would not be regarded as breaching the requirement.]

3.2.5 Under the bond arrangement, the bond-issuer issues instruments (**alternative bonds**) to the initial bond-holders evidencing their rights and interests in the specified asset;

[Remarks: Alternative bonds essentially represent sukuk certificates. This feature is one of the most significant ones differentiating sukuk from conventional bonds. The former represents the holders' undivided ownership in the underlying asset, while the latter only represents the debt owed by the bond-issuer to the bond-holders. As a religion-neutral approach is adopted, the proposed term "alternative bonds" is considered more appropriate than an Islamic term like "sukuk" to describe the instruments. We note that a similar term is also adopted in the UK legislation[9].]

3.2.6 Where the alternative bonds are transferable from one person to another, a transferee of any such alternative bond becomes a holder of the alternative bond (**subsequent bond-holder**) because of the transfer (any initial bond-holder or subsequent bond-holder is referred to as **bond-holder**);

[Remarks: This seeks to make clear that not only the initial investors but also the subsequent buyers of alternative bonds in the secondary market will be regarded as the

[9] Finance Act 2007 (2007 c 11), Section 53.

bond-holders and hence put in position comparable to subsequent buyers of conventional bonds.]

3.2.7 The investment arrangement provides for –

(a) the management, including disposal, of the specified asset with a view to generating income or gains (**investment return**); and

[Remarks: This provides that income or gains will be derived from the management of the specified asset. Management takes a very broad meaning, including leasing an asset, managing a venture, trading a portfolio of shares, disposing of an asset, etc.]

(b) the disposal of any specified asset which is still in the possession of the bond-issuer at the end of the specified term (the consideration for the disposal of the specified asset in paragraphs (a) and (b) is referred to as **proceeds of disposal**); and

[Remarks: This seeks to make clear that any remaining specified asset at the end of the specified term must be disposed of so as to unwind the whole arrangement. This feature does not exclude cases where there is an early redemption or cancellation of alternative bonds, so the transfer back of the remaining specified asset to the originator may take place earlier than originally scheduled. Nor does this feature exclude cases whereby the originator fails to make the redemption payment as described in paragraph 3.2.8(a) below, so the specified term may be extended to the date on which the redemption payment is made and the remaining specified asset may be held until that date. We intend to make clear the above in the DIPNs for the sake of clarity.]

3.2.8 The bond-issuer undertakes under the bond arrangement –

(a) to make a payment (**redemption payment**), whether or not by instalments, to the bond-holders during or at the end of the specified term to redeem the

alternative bonds;

[Remarks: The redemption payment is economically equivalent to the principal repayment in the case of conventional bonds. If the sukuk are issued at discount, the redemption payment will include the discount element. The same also applies to those sukuk issued at premium. This feature does not exclude cases where the redemption payment may be reduced as a result of a fall (i) in the value of the specified asset or (ii) in the rate of income or gains generated by the specified asset, which effectively means that asset-backed sukuk [10] can be accommodated under the bond arrangement. Nor does this feature exclude any redemption payment being satisfied by the transfer of shares (either those of the originator or of other companies). This effectively means that convertible and exchangeable sukuk can be covered under the bond arrangement. We intend to make clear the above in the DIPNs for the sake of clarity.]

(b) to make other payments (**additional payments**) to the bond-holders on one or more occasions during or at the end of the specified term; and

[Remarks: The additional payments are economically equivalent to the coupon payments in the case of conventional bonds. This proposed term is modeled on the UK legislation[11] and considered appropriate as it can cater for most cases no matter the coupon payments are made periodically or only at the end of the specified term. The amount of the additional payments may be fixed, determined by reference to

[10] Asset-backed sukuk usually involve a true sale of asset (i.e. transfer of both legal and beneficial ownership) without any purchase undertaking from the originator to buy back the asset. Sukuk-holders therefore will only have recourse to the underlying asset, but not to the originator, upon maturity or in the event of default. It is different from asset-based sukuk, where the sale of asset is not a true sale (i.e. transfer of beneficial interest only), and a purchase undertaking is usually in place for the originator to buy back the asset. Thus, sukuk-holders will only have recourse to the originator upon maturity or in the event of default.

[11] Corporation Tax Act 2009 (2009 c 4), Section 507, paragraph (1)(d)(iii).

the value of the specified assets or in some other ways. We intend to make clear the above in the DIPNs for the sake of clarity.]

(c) to use the investment return and part or all of the proceeds of disposal (to the extent that it does not form part of the investment return) under the investment arrangement for payment of the additional payments and redemption payment.
[Remarks: This feature does not exclude cases where the proceeds of disposal and investment return generated by the specified asset under the investment arrangement are insufficient to fund the expected amount of the additional payments and redemption payment to the bond-holders under the bond arrangement. We intend to make clear the above in the DIPNs.]

Please refer to **Annex 3** for a diagram illustrating the features above.

Question 1

Do you agree that the description in paragraph 3.2 can accurately reflect the general features of sukuk in the market? Please explain the reasons for your views.

B. Specific features of the three specified investment arrangements

3.3 Under our proposal, a specified investment arrangement is an investment arrangement contained in an alternative bond scheme where the investment arrangement meets the specific features as described in paragraph 3.4, 3.6 or 3.10 below. As a start, we propose to specify three specified investment arrangements in the legislation, with –

3.3.1 **leaseback arrangement** representing mainly Ijarah sukuk structure;

3.3.2 **profits sharing arrangement** representing business-plan Musharakah sukuk structure and Mudarabah sukuk structure; and

3.3.3 **purchase and sale arrangement** representing Murabahah sukuk structure.

Leaseback arrangement

3.4 Having regard to the key features of major Ijarah sukuk in the market, we propose that a leaseback arrangement must contain certain specific features along the following lines –

3.4.1 The bond-issuer uses the acquisition cost to acquire the specified asset from the originator;
[Remarks: This specific feature echoes the general feature of an investment arrangement under paragraph 3.2.4, but makes it clear that the specified asset must be acquired from the originator under an Ijarah sukuk structure. Given the wide definition of "asset" set out in footnote 8 of this document, the specified asset may include a leasehold interest that is granted to the bond-issuer by the originator by way of a lease out of the interest in the immovable property or other asset held by the originator. We intend to make clear the above in the DIPNs for the sake of

clarity.]

3.4.2 Subject to any partial redemption of the alternative bonds and replacement of asset, the bond-issuer is to hold the specified asset until the end of the specified term;
[Remarks: It is a common feature for the underlying asset to be held by the sukuk-issuer throughout the sukuk term under an Ijarah sukuk structure, unless there is replacement of asset or partial redemption of sukuk during the sukuk term.]

3.4.3 For the purposes of generating income or gains, the bond-issuer enters into a lease in respect of the specified asset under which the bond-issuer leases the specified asset back to the originator for a consideration (**specified income**); and
[Remarks: This specific feature echoes the general feature of an investment arrangement as described in paragraph 3.2.7(a), but makes it clear that income is generated by leasing the specified asset back to the originator under an Ijarah sukuk structure. Leasing of the asset will be effected by way of a sub-lease in the event that the specified asset is a leasehold interest as referred to in paragraph 3.4.1 above.]

3.4.4 Subject to any replacement of asset, the bond-issuer is to dispose of the specified asset to the originator, whether or not in stages, by the end of the specified term in return for the proceeds of disposal.
[Remarks: This specific feature echoes the general feature of an investment arrangement as described in paragraph 3.2.7(b), but makes it clear that the specified asset must be disposed of to the originator by the end of the specified term under an Ijarah sukuk structure. Disposal of the asset will be effected by way of surrender of a lease in the event that the specified asset is a leasehold interest as referred to in paragraph 3.4.1 above.]

Please refer to **Annex 4** for a diagram illustrating the features above.

Question 2

Do you agree that the description in paragraph 3.4 can accurately reflect the key features of the underlying structure of Ijarah sukuk in the market? Please explain the reasons for your views.

3.5 Under our proposal, a leaseback arrangement may provide for the replacement of an asset, as specified asset, during the specified term of the arrangement but must meet certain description along the following lines –

3.5.1 A leaseback arrangement may provide –

(a) for an asset (**original asset**) to be acquired, and leased for a segment of the specified term, in accordance with the description in paragraphs 3.4.1 and 3.4.3;

(b) for the description in paragraph 3.4.2 not to apply to the original asset, and for the bond-issuer to dispose of it to the originator before the end of the specified term;

(c) for the bond-issuer to acquire from the originator another asset (**first replacement asset**) to be held as specified asset under the arrangement, leased in accordance with the description in paragraph 3.4.3 and held and disposed of in accordance with the description in paragraphs 3.4.2 and 3.4.4.

[Remarks: This seeks to describe the situation where the bond-issuer needs to replace an underlying asset with another asset from the originator during the specified term because the asset is no longer Shariah-compliant or for some other reasons.]

3.5.2 A leaseback arrangement may also provide for further replacement. That means, in relation to the first replacement asset or any asset acquired as described in this paragraph as specified asset (each referred to as **asset being replaced**) –

(a) the asset being replaced is to be leased for a segment of the specified term in accordance with the description in paragraph 3.4.3; and

(b) the description in paragraph 3.4.2 is not to apply to the asset being replaced, and the bond-issuer is to dispose of it to the originator before the end of the specified term; and

(c) the bond-issuer is to acquire from the originator another asset to be held as specified asset under the arrangement, leased in accordance with the description in paragraph 3.4.3 and held and disposed of in accordance with the description in paragraphs 3.4.2 and 3.4.4.

[Remarks: This seeks to describe the situation where the bond-issuer needs to further replace the underlying asset with another asset from the originator during the specified term.]

3.5.3 If any asset held by the bond-issuer as specified asset under a leaseback arrangement is destroyed or lost during the specified term, and –

(a) if there are no remains of the asset, the bond-issuer may use any insurance money and other compensation of any description arising in respect of the destruction or loss; or

(b) if there are remains of the asset, the bond-issuer may dispose of any remains of the asset to the originator before the end of the specified term and use any consideration for the disposal and any insurance money and other compensation of any description arising in respect of the destruction or loss

to acquire from the originator another asset to be held as

specified asset under the arrangement, to be leased in accordance with the description in paragraph 3.4.3 and to be held and disposed of in accordance with the description in paragraphs 3.4.2 and 3.4.4.

[Remarks: This seeks to describe the situation where an underlying asset has been destroyed or lost, and insurance proceeds are received by the bond-issuer to acquire another asset from the originator to replace the original one in order to avoid early redemption.]

Question 3

Do you agree that the description in paragraph 3.5 can accurately describe the asset replacement scenarios? Please explain the reasons for your views.

Profits sharing arrangement

3.6 Having regard to the key features of major business-plan Musharakah sukuk and Mudarabah sukuk in the market, we propose that a profits sharing arrangement must contain certain specific features along the following lines –

3.6.1 The bond-issuer and the originator enter into a business undertaking –

(a) by the bond-issuer contributing the acquisition cost to the business undertaking in return for an interest in it; and

(b) by the originator contributing to the business undertaking in either of the following ways in return for an interest in it –

(i) contributing a sum of money or in kind or both;

(ii) contributing expertise and management skills;

[Remarks: This specific feature echoes the general feature

of an investment arrangement as described in paragraph 3.2.4, but makes it clear that the bond-issuer must acquire an interest in a business undertaking as the underlying asset through entering into a business undertaking with the originator under the business-plan Musharakah and Mudarabah sukuk structures. There are however differences on the part of the originator under these two structures. The originator under a business-plan Musharakah sukuk structure makes a contribution in cash or in kind or both to the business undertaking, while the originator under a Mudarabah sukuk structure contributes its expertise and management skills to the business undertaking with responsibility for managing the bond-issuer's cash contribution.]

3.6.2 Subject to partial redemption of the alternative bonds, the bond-issuer is to hold the interest in the business undertaking as the specified asset until the end of the specified term;

[Remarks: It is a common feature for the sukuk-issuer to hold its interest in the venture throughout the sukuk term under the business-plan Musharakah and Mudarabah sukuk structures, unless there is partial redemption of sukuk.]

3.6.3 For the purposes of generating income or gains over the specified term, the business undertaking carries on business activities in accordance with the terms of the arrangement. The business activities include –

(a) acquiring an asset from the originator;

(b) leasing an asset to the originator for a consideration; and

(c) disposing of an asset to the originator;

and to avoid doubt, a reference to asset above includes –

(i) an asset that is the originator's contribution in kind to the business undertaking referred to in paragraph 3.6.1(b)(i) (**original asset**);

(ii) any other asset replacing the original asset; and

(iii) any subsequent replacement assets;

[Remarks: This specific feature echoes the general feature of an investment arrangement as described in paragraph 3.2.7(a), but makes it clear that income or gains are generated by the business undertaking through carrying on business activities in accordance with pre-agreed business plan. Apart from the description above, the business activities may also include engaging in a property development project, acquiring and managing the business operations of a company, etc. This will be made clear in the DIPNs.]

3.6.4 As to any profits generated, and any losses incurred, by the business undertaking –

(a) if the originator contributes a sum of money or in kind or both as referred to in paragraph 3.6.1(b)(i) above, the bond-issuer shares with the originator –

(i) the profits in accordance with the profit sharing ratios set out in the arrangement, and

(ii) the losses in proportion to the capital contributions of the bond-issuer and the originator; or

(b) if the originator contributes expertise and management skills as referred to in paragraph 3.6.1(b)(ii) above, the bond-issuer –

(i) shares with the originator the profits in accordance with the profit sharing ratios set out in the arrangement, and

(ii) bears the losses

(the profits due to the bond-issuer, less the losses borne by the bond-issuer, are referred to as **specified return**);

[Remarks: The profit sharing mechanism as described in paragraph (a) is applicable to a business-plan Musharakah sukuk structure, while that described in paragraph (b) is applicable to a Mudarabah sukuk structure. It is possible that the profits to be shared by the bond-issuer are not equal to the expected return payable to the bond-holders. In most cases, to the extent that the profits receivable by the bond-issuer in any period are greater than the expected

return in that period, the originator as the managing agent will receive such excess as an advance incentive fee (most likely to be kept in a sinking fund). In the event that there is any shortfall between the profits receivable by the bond-issuer and the expected return payable to the bond-holders, the originator will be obliged to return such advance incentive fee to make good the shortfall. At the end of the specified term, any advance incentive fee not required to be returned to the bond-issuer can be conclusively retained by the originator as the managing agent. This feature can effectively turn the Musharakah and Mudarabah sukuk structures from equity-like arrangements to debt-like arrangements. Thus, the specified return in this feature is intended to exclude any excess profits returned to the originator as an (advance) incentive fee. We intend to make clear the above in the DIPNs for the sake of clarity.]

3.6.5 The bond-issuer is to dispose of its interest in the business undertaking to the originator, whether or not in stages, by the end of the specified term in return for the proceeds of disposal.

[Remarks: This specific feature echoes the general feature of an investment arrangement as described in paragraph 3.2.7(b), but makes it clear that the bond-issuer's interest in the business undertaking, as specified asset, must be disposed of to the originator by the specified term, whether or not in stages. This feature can also accommodate a diminishing Musharakah sukuk structure[12]. In view that a purchase undertaking with a fixed purchase price has become a challenge after the statement of the Accounting and Auditing Organization for Islamic Financial Institutions in 2008[13], this feature does not exclude cases where the

[12] The bond-issuer's interest in the business undertaking will decrease over the life of the sukuk under a diminishing Musharakah sukuk structure.

[13] The Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") is a standard-setting body based in Bahrain which develops accounting, auditing, governance and Shariah standards for the Islamic financial industry. In 2008, AAOIFI released a statement stating that it was not permissible for an originator to grant a purchase undertaking to the bond-issuer to purchase the musharakah assets at a fixed exercise price determined by reference to a formula, e.g. at a price equal

amount of the proceeds of disposal is equal to the fair market value of the bond-issuer's share in the business undertaking at the time of sale.]

Please refer to **Annex 5** for a diagram illustrating the features above.

Question 4

Do you agree that the description in paragraph 3.6 can accurately reflect the key features of the underlying structure of business-plan Musharakah and Mudarabah sukuk in the market? Please explain the reasons for your views.

3.7 As advised by major market players, apart from the business-plan Musharakah sukuk structure, Musharakah sukuk can also be structured on the concept of co-ownership of assets (**co-ownership Musharakah sukuk structure**), under which the originator and bond-issuer contribute cash to purchase an asset together (**scenario 1**) or the originator sells part of its ownership interest in an asset to the bond-issuer as a result of which the originator and bond-issuer become co-owners of that asset (**scenario 2**).

3.8 Under the co-ownership Musharakah sukuk structure, there may not be any business undertaking between the originator and bond-issuer, and the sukuk only represent the holders' ownership interest in the underlying asset. In some cases, the profit sharing ratio is not required because the bond-issuer may simply lease its share of the asset to the originator in return for rental income and the entire rent is due to the bond-issuer as the lessor. The originator undertakes to purchase the bond-issuer's share in the

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to the face value of the sukuk. This was viewed as being akin to a guarantee of profit and principal, which, unless given by an independent third party, is not permitted under Shariah. Instead, the exercise price must be the market value of the assets at the time of sale.

underlying asset either in the event of default or upon maturity.

3.9 As we see it, scenario 2 above involving leasing structure as described in paragraph 3.8 can fit into the leaseback arrangement in paragraph 3.4, as references to "asset" may include references to "a share of asset". Under the prescriptive approach, there will not be any specific reference to Shariah names or principles in the legislation. Thus, the leaseback arrangement is not confined to Ijarah sukuk structure, and also covers any other sukuk structures which contain the key features of the leaseback arrangement as described in paragraph 3.4.

Question 5

Do you agree that co-ownership Musharakah sukuk structure can be accommodated under the leaseback arrangement? If not, please explain the reasons for your views and the detailed structure of this kind of sukuk in the market.

Purchase and sale arrangement

3.10 Having regard to the key features of major Murabahah sukuk in the market, we propose that a purchase and sale arrangement must contain certain specific features along the following lines –

3.10.1 The bond-issuer acquires the specified asset from a third party on immediate payment of the acquisition cost to that third party;

[Remarks: This specific feature echoes the general feature of an investment arrangement as described in paragraph 3.2.4, but makes it clear that the bond-issuer must acquire an asset from a third party under a Murabahah sukuk structure. The asset may be commodities or other assets, but the purchase price of the asset must be paid immediately. The third party may be a broker, commodity

supplier or any other person. To streamline the administrative process, the bond-issuer may sometimes appoint the originator as its buying agent to acquire the asset. Such arrangement is not excluded from this feature and will be made clear in the DIPNs for the sake of clarity.]

3.10.2 For the purposes of generating income or gains, the bond-issuer, on acquiring the specified asset, immediately disposes of it onward to the originator in return for the proceeds of disposal, which –

(a) is of an amount equal to the acquisition cost plus a markup (**markup**);

(b) is payable on deferred payment terms, in a lump sum or by instalments; and

[Remarks: This specific feature echoes the general feature of an investment arrangement as described in paragraph 3.2.7(a), but makes it clear that gains are generated by immediately disposing of the underlying asset to the originator at a higher price under a Murabahah sukuk structure. The price of the asset is typically equal to the purchase price plus a pre-agreed markup, and payable on deferred payment terms.]

3.10.3 On the acquisition of the specified asset from the bond-issuer, the originator either –

(a) immediately disposes of the asset onward to another third party against immediate payment of a price equal to the acquisition cost; or

[Remarks: This feature applies to a Murabahah sukuk structure based on commodity trading. The ultimate goal of the originator under this structure is to obtain the use of the bond proceeds during the specified term by disposing of the asset to another party immediately in return for a price equal to the acquisition cost (i.e. the bond proceeds raised from the bond-holders). As advised by major market players, most Shariah scholars require the party to whom the originator sells the asset to be different

from the party selling the asset to the bond-issuer in the first place. Thus, only this scenario is intended to be accommodated under this feature. See paragraphs 3.11 and 3.12 below for more details.]

(b) retains the asset for the originator's own use.
[Remarks: This feature applies to a Murabahah sukuk structure for asset-financing. The ultimate goal of the originator under this structure is to obtain the asset for its own use.]

Please refer to **Annex 6** for a diagram illustrating the features above.

Question 6

(a) Do you agree that the description in paragraph 3.10 can accurately reflect the key features of the underlying structure of Murabahah sukuk in the market? Please explain the reasons for your views.

(b) The description in paragraphs 3.10.1 to 3.10.3(a) above is mainly intended to cater for a fixed-rate commodity Murabahah sukuk structure. Is it very common to see a floating-rate commodity Murabahah sukuk structure in the market? If so, please explain the detailed operations of this kind of structure.

(c) Is it very common to see replacement of asset due to destruction or loss under a Murabahah sukuk structure? If so, please explain the detailed arrangement under this scenario.

3.11 As advised by major market players, while it is technically feasible for the bond-issuer to buy an asset from the originator and then sell it back to the originator at a higher price, since such structure involves sale and buy-back of the asset between two parties within a short period of time, it is prohibited by the majority of Shariah

scholars. We therefore propose to exclude this structure from the current legislative exercise.

3.12 In addition to the above, it may also be possible for the bond-issuer to buy an asset from an associate of the originator and then immediately sell the asset onward to the originator who then sells it back to that associate. Since the originator and its associate are related parties, this kind of structure is also prohibited by the majority of Shariah scholars. We therefore also propose to exclude this structure from the current legislative exercise.

Power to add specified investment arrangements and amend the specific features of specified investment arrangements by subsidiary legislation subject to negative vetting by LegCo

3.13 With a view to keeping pace with market developments and needs in a more timely manner, we propose that FS may, by notice published in the Gazette (which will be subsidiary legislation subject to negative vetting by LegCo), inter alia, add any investment arrangement as a specified investment arrangement and amend the specific features of any specified investment arrangement in the future.

[Remarks: The proposed use of notice, which will be subsidiary legislation subject to negative vetting by LegCo, seeks to strike a reasonable balance between satisfying the need for scrutiny by the legislature and due process, and the need for flexibility and timely responses to evolving market developments. Under our proposal, FS' power is not unrestrained as the new or varied specified investment arrangements must still be an investment arrangement as defined in paragraph 3.2 and the definition of investment arrangement cannot be amended by FS by subsidiary legislation.]

C. Conditions to be met for a bond arrangement and an investment arrangement to qualify for special tax treatment

Qualified bond arrangement

3.14 Under our proposal, a bond arrangement must be a **qualified bond arrangement** in order to be eligible for special tax treatment, i.e. regarded as a debt arrangement, under IRO. For a bond arrangement in an alternative bond scheme to be a qualified bond arrangement at any time (**material time**), we propose that certain qualifying conditions along the following lines must be complied with –

3.14.1 The alternative bond scheme is and, from the commencement of the specified term up to the material time, has always been **a specified alternative bond scheme**;

3.14.2 The bond arrangement complies and, from the commencement of the specified term up to the material time, has always complied with –

(a) **the limit on return condition**; and

(b) **the bond arrangement as financial liability condition**; and

3.14.3 The alternative bond scheme complies and, from the commencement of the specified term up to the material time, has always complied with –

(a) **the maximum term length condition**; and

(b) **the arrangements performed according to tenor condition**.

A specified alternative bond scheme

3.14.4 A scheme (**scheme**), containing 2 arrangements (**arrangement A** and **arrangement B**), is a specified alternative bond scheme at any time (**material time**) if –

(a) arrangement A is a bond arrangement and has always been a bond arrangement from the commencement of the specified term of the scheme up to the material time; and

(b) arrangement B is a specified investment arrangement and has always been a specified investment arrangement from the commencement of the specified term of the scheme up to the material time.

[Remarks: This condition seeks to ensure that the scheme in question is a specified alternative bond scheme containing two arrangements, the terms of which meet and have always met the essential features of the bond arrangement and specified investment arrangement respectively. Since the alternative bond scheme represents the whole framework of a sukuk issuance, we consider it necessary to ensure that the whole framework can satisfy the requisite features before any arrangement in it can claim the special tax treatment.]

Limit on return condition

3.14.5 A bond arrangement in an alternative bond scheme complies with the limit on return condition if –

(a) the CIR is satisfied that in each period beginning on the commencement of the specified term of the scheme and ending on a date on which an additional payment, or the redemption payment or part of it, may under the terms of the bond arrangement be payable, the maximum total amount of the bond return that may under the terms of the bond arrangement be payable must not exceed an amount that would be a reasonable commercial return on money borrowed of the amount of the bond proceeds; and

(b) in each period beginning on the commencement of

the specified term of the scheme and ending on a date on which an additional payment, or the redemption payment or part of it, is actually paid under the bond arrangement, the total amount of the bond return actually paid under the bond arrangement must not exceed an amount that would be a reasonable commercial return on money borrowed of the amount of the bond proceeds.

3.14.6 For the purposes of the limit on return condition –

(a) bond return paid or payable in a period in the specified term is equal to –

(i) the amount of the redemption payment or part of it that is paid or payable in the period; *minus*

(ii) the corresponding portion of the bond proceeds; *plus*

(iii) the total amount of additional payments paid or payable in the period.

(b) any additional payment, or the redemption payment or any part of it, paid or payable under a bond arrangement after the end of the specified term is to be treated as if it had been paid or payable at the end of the specified term.

[Remarks:

- This condition is designed to screen out equity or equity-like instruments which offer return that is above what would be reasonable commercial return for debt securities so that only those sukuk economically equivalent to debt securities will be accommodated under our regime. This condition is considered appropriate since our regime seeks to treat qualified bond arrangement as debt arrangement. Thus, it would be necessary for the bond arrangement in question to be economically equivalent to a debt arrangement in the first place.
- The test in this condition is divided into 2 steps: with the first one in paragraph 3.14.5(a) based on

estimation (i.e. bond return payable in future) while the second one in paragraph 3.14.5(b) based on known facts (i.e. bond return actually paid in the past).

- In the first step, the CIR will first break down the whole specified term into a number of periods, with each period starting from the commencement of the specified term up to the date of payment of the additional payments (or the redemption payment in the case of zero-coupon alternative bonds). The CIR has to be satisfied that the amount of the bond return payable on the alternative bond in question in each period does not exceed that of the coupon payments or discount / premium (as the case may be) of a conventional debt security carrying similar tenor, currency, issue date, credit risk, conversion right (if applicable), etc., in that period. In order to cater for floating-rate alternative bonds where the coupon rate is not fixed at the beginning of the specified term, the maximum amount of the bond return is used for comparison.
- In the second step, the CIR will check the actual amount of the bond return paid in each aforesaid period for compliance checking purposes.
- For normal alternative bonds with periodic coupon payments, the bond return refers to the additional payments. As for zero-coupon alternative bonds, the bond return is the excess of the redemption payment over the bond proceeds, which is essentially the premium or discount of a bond. For some cases where the alternative bonds carry both coupon payments and premium / discount element, the bond return is equal to the sum of the two.
- There is a similar condition in the UK legislation[14], but our version imposes the additional condition under which we look at not only the whole sukuk term, but also each individual period during the sukuk term as

[14] Corporation Tax Act 2009 (2009 c 4), Section 507, paragraph (1)(e).

mentioned above. Thus, even if the maximum total amount of the bond return payable on an alternative bond does not exceed a reasonable commercial return on money borrowed as far as the whole sukuk term is concerned, it may still be screened out under our regime if it is making extremely volatile coupon payments which are not based on any benchmark rate during the sukuk term. We consider it justifiable to adopt a stricter test so as to prevent any abuse of our regime by disguising an equity-like instrument as a debt arrangement or making excessive claims of additional payments in the early part of the specified term.

- The proposed provision in paragraph 3.14.6(b) is intended to prevent any abuse whereby the bond-issuer intentionally defers the payments of the redemption payment and/or additional payments beyond the specified term. Any such payments will still be counted as part of the bond return for the purposes of the limit on return condition.]

Bond arrangement as financial liability condition

3.14.7 A bond arrangement in an alternative bond scheme complies with the bond arrangement as financial liability condition if the bond arrangement –

(a) is treated as a financial liability of the bond-issuer in accordance with the International Financial Reporting Standards (issued by the International Accounting Standards Board) or the Hong Kong Financial Reporting Standards (issued by the Hong Kong Institute of Certified Public Accountants); or

(b) would be treated as a financial liability of the bond-issuer if the bond-issuer applied those standards.

[Remarks:

- This condition seeks to distinguish from an accounting

perspective those sukuk which are in economic substance equivalent to debt securities from those that are equity or equity-like instruments. The former should normally be reflected as a financial liability while the latter should be an equity.

- There is a similar condition in the UK legislation[15], and our proposed version has added Hong Kong financial reporting standards as one of the recognised financial reporting standards to cater for the situation of Hong Kong.
- In practice, even if a bond-issuer has not adopted the international or Hong Kong financial reporting standards, the condition is still considered to be met if the CIR is satisfied that the instrument would be treated as a financial liability if any of those standards were applied.
- This condition does not exclude cases where the bond arrangement is only partly treated as a financial liability, e.g. exchangeable / convertible sukuk. This will be made clear in the DIPNs for the sake of clarity.]

Maximum term length condition

3.14.8 An alternative bond scheme complies with the maximum term length condition if its specified term is not longer than 10 years.

3.14.9 To cater for fast-evolving market developments, we propose that FS may, by notice published in the Gazette (which will be subsidiary legislation subject to negative vetting by LegCo), amend the aforesaid period in the future.

[Remarks:

- This condition effectively limits the tenor of sukuk that can be accommodated under our regime to 10

[15] Corporation Tax Act 2009 (2009 c 4), Section 507, paragraph (1)(i)

years. The proposed period seeks to strike a reasonable balance between the need to facilitate market development and the need to address tax avoidance concerns.

- In the event of withdrawal of special tax treatment, the ability of the CIR to fully recover the tax payments hinges on the information available from the commencement of the sukuk term provided by the originator, bond-issuer and third parties.
- While it is our intention to extend the record-keeping period in respect of transactions under the bond arrangement and investment arrangement to 7 years after the end of the specified term (instead of 7 years after the completion of the relevant transactions) as proposed in paragraph 3.20, this proposed requirement will only be binding on the originator and bond-issuer. As for third parties like banks, they will still be subject to the normal record-keeping period of 7 years after the completion of the relevant transactions as set out in the existing sections 51C and 51D of IRO.
- In case there is a non-compliance in the later part of the sukuk term, the longer the sukuk tenor, the higher the risk that the records of transactions conducted in the early part of the sukuk term might not be made available by the third parties, rendering it difficult for the CIR to probe into cases to fully recover the profits tax payable from the commencement of the sukuk term in the event of withdrawal of special tax treatment.
- On the other hand, we understand from major market players that most sukuk in the market have a tenor of 10 years or below.[16] In addition, we note that there is also a time limit of 10 years on the transfer back of the asset to the originator, which effectively limits the sukuk term to 10 years, under the UK legislation[17].

[16] According to a sukuk report published by International Islamic Financial Market, the tenors of the sukuk issued in the international market between September 2001 and June 2009 have been concentrated in the 5-year bracket, with 68 out of 77 issues having a maturity of 5 years.
[17] Finance Act 2009 (2009 c10), Schedule 61, paragraph 5(11)(b).

- After balancing the relevant factors mentioned above, we propose to set a limit on the sukuk term at 10 years as a starting point and will review the need to adjust this time limit in the future having regard to the prevailing market developments and our experience in implementing the legislative proposals upon its introduction.
- At the same time, in order to allow timely responses to the fast-changing market developments in the future, we propose to provide FS with the power to amend the specified term limit by subsidiary legislation subject to negative vetting by LegCo. We note that there is also a similar provision under the UK legislation[18].]

Arrangements performed according to tenor condition

3.14.10 An alternative bond scheme complies with the arrangements performed according to tenor condition if the bond arrangement and investment arrangement in the scheme are performed according to the tenor of the arrangements as described in paragraph 3.2 and in paragraph 3.4, 3.6 or 3.10 that is relevant to the investment arrangement.

[Remarks:

- This condition seeks to ensure that the actual performance of the bond-issuer and originator during the specified term accords with the terms of the arrangements so as to prevent any potential abuse by disguising an arrangement as a bond arrangement or one of the specified investment arrangements at the start so as to qualify for the special tax treatment but then reverting the arrangement to its original form in the middle of the specified term.
- As an example, in case the terms of an Ijarah sukuk issue specified in the offering documents can meet

[18] Finance Act 2009 (2009 c10), Schedule 61, paragraph 5(12).

the description of a leaseback arrangement proposed in paragraph 3.4 at the start of the sukuk term, but the sukuk-issuer ends up selling the underlying asset to a third party rather than the originator at the end of the sukuk term, which deviates from the specified terms of the arrangement, we consider it justifiable to disqualify the arrangement as it no longer falls within the intended scope of our regime.]

Additional condition being considered

3.14.11 Apart from the qualifying conditions above, we intend to include a condition along the lines that the alternative bonds issued under the bond arrangement should be **listed**, **issued** or **marketed**, in whole or in part, in Hong Kong. In other words, meeting at least one of these three criteria will be able to satisfy the proposed condition. This is intended to ensure that the alternative bonds eligible for the special tax regime will have some nexus with Hong Kong in a way that will help promote the development of sukuk market and encourage the use of the Islamic finance platform here. This would also provide flexibility to cater for sukuk offered through private placement (which are unlisted), as either issuance or distribution in Hong Kong would be able to satisfy the proposed condition. This is in line with our policy intention that both listed and unlisted sukuk, so long as meeting the relevant features and conditions, will be covered in our regime.

Qualified investment arrangement

3.15 Under our proposal, an investment arrangement must be a **qualified investment arrangement** in order to be eligible for special tax treatment, i.e. regarded as a debt arrangement, under IRO. For an investment arrangement in an alternative bond scheme to be a qualified investment arrangement at any time (**material time**), we propose that certain conditions along the

following lines must be complied with –

3.15.1 The alternative bond scheme and the bond arrangement are and, from the commencement of the specified term up to the material time, have always been a specified alternative bond scheme and **a qualified bond arrangement** respectively;

3.15.2 The alternative bond scheme complies and, from the commencement of the specified term up to the material time, has always complied with –

(a) **the bond-issuer as conduit condition**; and

(b) **the diverse holding condition**; and

3.15.3 The investment arrangement complies and, from the commencement of the specified term up to the material time, has always complied with **the investment arrangement as financial liability condition**.

Qualified bond arrangement

3.15.4 Given that the overriding objective of this legislative exercise is to level the playing field for sukuk vis-à-vis conventional bonds in terms of tax liabilities, it would be necessary to ensure that the alternative bond issued under a bond arrangement is economically equivalent to a debt security and falls within the intended scope of our regime in the first place. This can be evidenced by the bond arrangement being qualified as a qualified bond arrangement. If the alternative bond issued under the bond arrangement is in substance equivalent to an equity instrument or falls outside the scope of our regime, there will be no reasonable grounds to apply special tax treatment to the investment arrangement, which is in essence the underlying structure of the alternative bond issued under the bond arrangement.

Bond-issuer as conduit condition

3.15.5 An alternative bond scheme complies with the bond-issuer as conduit condition if –

(a) the CIR is satisfied that, in each period beginning on the commencement of the specified term of the scheme and ending on a date on which an additional payment, or the redemption payment or any part of it, may under the terms of the bond arrangement be payable, the maximum total amount of the investment return that may under the terms of the investment arrangement in the scheme be payable must not exceed the maximum total amount of the bond return that may under the terms of the bond arrangement in the scheme be payable; and

(b) in each period beginning on the commencement of the specified term and ending on a date on which an additional payment, or the redemption payment or part of it, is actually paid under the bond arrangement, the total amount of the investment return actually paid under the investment arrangement must not exceed the total amount of the bond return actually paid under the bond arrangement.

[Remarks:

- This condition seeks to ensure that the bond-issuer merely acts as a conduit and any excess return would ultimately be returned to the originator, which is a distinct feature of most asset-based sukuk in the market.
- This condition only excludes cases where the investment return is greater than the bond return. In most cases, it is expected that the investment return would be equal to the bond return. But in some cases, the investment return may be less than the bond return as the shortfall may be financed by credit enhancement measures provided by a third party other than the originator, e.g. the parent company of the originator.

- Similar to the limit on return condition, there are two steps under this condition to ensure that this condition is complied with at all times during the specified term.]

3.15.6 Paragraph 3.14.6 relating to the calculation of the bond return under a bond arrangement applies for the purposes of the preceding paragraph, just as it applies to the calculation of the bond return under a bond arrangement for the purposes of paragraph 3.14.5.

3.15.7 The investment return for each specified investment arrangement is to be calculated in accordance with the ensuing paragraphs.

3.15.8 In relation to a leaseback arrangement, the investment return paid or payable in a period in the specified term is equal to –

(a) the specified income paid or payable in the period; *plus*
(b) the specified proceeds of disposal; *minus*
(c) the specified acquisition cost; *plus*
(d) any other amount paid or payable by the originator to the bond-issuer in the period

[Remarks:

- This formulation seeks to ensure that, in addition to the specified income, any excess of the proceeds of disposal over the acquisition cost, as well as any other amount paid or payable by the originator to the bond-issuer, will be included in the investment return for the purposes of the bond-issuer as conduit condition.
- The inclusion of other amount paid or payable by the originator to the bond-issuer seeks to ensure that any income other than the specified income received and retained by the bond-issuer will be taken into account in calculating the investment return. More details

will be elaborated in the DIPNs for the sake of clarity.]

where –
specified acquisition cost refers –

(i) in relation to a period in which the whole of the specified asset is or is to be disposed of, to the acquisition cost of the specified asset; or

(ii) in relation to a period in which a part of the specified asset is or is to be disposed of, to that part of the acquisition cost that is attributable to that part of the specified asset; and

specified proceeds of disposal refers –

(i) in relation to a period in which the whole of the specified asset is or is to be disposed of, to the proceeds of disposal of the specified asset; or

(ii) in relation to a period in which a part of the specified asset is or is to be disposed of, to that part of the proceeds of disposal that is attributable to that part of the specified asset.

[Remarks: Paragraphs (ii) under the two definitions above are intended to cater for partial redemption scenario. In case no asset is disposed of during the period, the specified proceeds of disposal and specified acquisition cost would be zero.]

3.15.9 In relation to a leaseback arrangement to which paragraph 3.5 relating to replacement of asset applies, the investment return paid or payable in a period in the specified term is equal to –

(a) the sum of –

(i) the aggregate of the specified income for the leasing referred to in paragraph 3.4.3 as modified by paragraph 3.5 of each asset held as specified asset during the period; and

(ii) any amount deemed to be specified income as

proposed in paragraph 3.15.10 below; *plus*

(b) the specified proceeds of disposal; *minus*

(c) the specified acquisition cost; *plus*

(d) any other amount paid or payable by the originator to the bond-issuer in the period

where –

(i) acquisition cost means the acquisition cost referred to in paragraph 3.4.1;

(ii) proceeds of disposal means the proceeds of disposal referred to in paragraph 3.4.4, as modified by paragraph 3.5;

(iii) specified acquisition cost is the amount bearing the same ratio to the acquisition cost as the specified proceeds of disposal bears to the proceeds of disposal;

(iv) specified proceeds of disposal is the amount paid or payable in the period towards satisfaction of the proceeds of disposal.

[Remarks: This proposed provision seeks to make clear how the investment return will be affected by replacement of asset.]

3.15.10 Where –

(a) apart from the asset being replaced, any consideration is paid or payable by the originator to the bond-issuer for any replacement referred to in paragraph 3.5.1 or 3.5.2; or

(b) any consideration for disposal, insurance money or compensation referred to in paragraph 3.5.3 received or receivable by the bond-issuer is not or is not to be returned to the originator for any acquisition referred to in paragraph 3.5.3

the consideration for replacement or disposal or insurance money or compensation (except to the extent that is paid to the bond-issuer towards satisfaction of the proceeds of disposal) is to be treated as specified income in respect of

the asset replaced, destroyed or lost (as the case requires) for the purposes of the calculation of the investment return under a leaseback arrangement in the preceding paragraph.

[Remarks: This proposed provision is designed to prevent abuse whereby the bond-issuer keeps any consideration or insurance money arising from the replacement, destruction or loss of asset, which is not returned to the originator or passed on to the bond-holders as the redemption payment. With this provision, any such consideration or insurance money will be counted as part of the specified income for the purposes of the bond-issuer as conduit condition.]

3.15.11 In relation to a profits sharing arrangement, the investment return paid or payable in a period in the specified term is equal to –

(a) the specified return paid or payable in the period; *plus*
(b) the specified proceeds of disposal; *minus*
(c) the specified acquisition cost; *plus*
(d) any other amount paid or payable by the originator or business undertaking to the bond-issuer in the period

[Remarks:

- Similar to the leaseback arrangement, this formulation seeks to ensure that, in addition to the specified return, any excess of the proceeds of disposal over the acquisition cost, as well as any other amount paid or payable by the originator or business undertaking to the bond-issuer, will be included in the investment return for the purposes of the bond-issuer as conduit condition.
- Other amount paid or payable by the originator or business undertaking to the bond-issuer is intended to include any top-up amount received by the bond-issuer from the originator in case the profits receivable by the bond-issuer are smaller than the expected return

payable to the bond-holders. More details will be elaborated in the DIPNs for the sake of clarity.]

where –
specified acquisition cost refers –

(i) in relation to a period in which the whole of the specified asset is or is to be disposed of, to the acquisition cost of the specified asset; or
(ii) in relation to a period in which a part of the specified asset is or is to be disposed of, to that part of the acquisition cost that is attributable to that part of the specified asset; and

specified proceeds of disposal refers –

(i) in relation to a period in which the whole of the specified asset is or is to be disposed of, to the proceeds of disposal of the specified asset; or
(ii) in relation to a period in which a part of the specified asset is or is to be disposed of, to that part of the proceeds of disposal that is attributable to that part of the specified asset.

3.15.12 In relation to a purchase and sale arrangement, the investment return paid or payable in a period in the specified term is equal to –

(a) the markup, or part of it, that is paid or payable in the period; *plus*
(b) any other amount paid or payable by the originator to the bond-issuer in the period.

3.15.13 For the purposes of the calculation of the investment return as described in paragraphs 3.15.8 to 3.15.12, any investment return paid or payable under the investment arrangement after the end of the specified term is to be treated as if it had been paid or payable at the end of the specified term.

[Remarks: This proposed provision seeks to prevent abuse whereby the originator intentionally defers the payments

of the investment return beyond the specified term. Any such payments will still be counted as part of the investment return for the purposes of the bond-issuer as conduit condition.]

3.15.14 If, under any of the specified investment arrangements above, assets held as specified asset are or are to be disposed of in parts, we propose that the CIR may, for the purposes of the calculation of the investment return under the investment arrangement and having regard to all the circumstances of the investment arrangement, allocate a part of the acquisition cost as attributable to each part of the assets.

[Remarks: This proposed provision seeks to empower the CIR to apportion the acquisition cost in partial redemption scenario for the purposes of calculating the investment return.]

Diverse holding condition

3.15.15 An alternative bond scheme complies with the diverse holding condition if the aggregate of alternative bonds issued under the bond arrangement in the scheme that are beneficially held by or are acquired with funds provided, directly or indirectly, by specified holders does not exceed 50% of the total alternative bonds issued under the bond arrangement.

3.15.16 For the purposes of the above, specified holder means any of the following –

(a) the originator;
(b) the bond-issuer;
(c) an associate of the originator;
(d) an associate of the bond-issuer;

where associate has the same meaning as in section 14A (charge on assessable profits from QDI) of IRO.

[Remarks: This condition seeks to promote wide

ownership of sukuk and prevent possible abuse of the special tax treatment by the bond-issuer and originator. See more details on the definition of "associate" in paragraph 3.31 below.]

Investment arrangement as financial liability condition

3.15.17 An investment arrangement in an alternative bond scheme complies with the investment arrangement as financial liability condition if the investment arrangement –

(a) is treated as a financial liability of the originator in accordance with the International Financial Reporting Standards (issued by the International Accounting Standards Board) or the Hong Kong Financial Reporting Standards (issued by the Hong Kong Institute of Certified Public Accountants); or

(b) would be treated as a financial liability of the originator if the originator applied those standards.

[Remarks:

- This condition seeks to distinguish from an accounting perspective those arrangements which are in economic substance equivalent to debt arrangements from those that are equity arrangements or involve true sale of asset.
- In practice, even if an originator has not adopted the international or Hong Kong financial reporting standards, the condition is still considered to be met if the CIR is satisfied that the arrangement would be treated as a financial liability if any of those standards were applied.]

Question 7

Do you agree with the qualifying conditions proposed for the bond arrangement and investment arrangement under IRO? Please explain the reasons for your views.

D. Special tax treatment applicable to a qualified bond arrangement and a qualified investment arrangement

Qualified bond arrangement

3.16 We propose that a qualified bond arrangement be eligible for the special tax treatment along the following lines for the purposes of IRO –

3.16.1 The qualified bond arrangement is to be regarded as a debt arrangement;

3.16.2 The bond proceeds paid by the bond-holders to the bond-issuer under the qualified bond arrangement are to be regarded as money borrowed by the bond-issuer from the bond-holders;

3.16.3 The additional payments payable by the bond-issuer to the bond-holders under the qualified bond arrangement are to be regarded as interest payable on that money borrowed by the bond-issuer from the bond-holders;
[Remarks: This seeks to treat coupon payments payable on sukuk as interest payable on conventional bonds for profits tax purposes; otherwise the former may be treated as profit distributions which are not tax deductible.]

3.16.4 The bond-holders are to be regarded as not having any legal or beneficial interest in the specified asset under the specified alternative bond scheme;
[Remarks: This seeks to remove any unintended tax implications on bond-holders in view that sukuk certificates evidence the holders' ownership in the underlying asset in Islamic context.]

3.16.5 The bond-issuer is to be regarded as not being a trustee in respect of the specified asset under the specified alternative bond scheme;
[Remarks: This seeks to remove doubt on whether the

bond arrangement would fall within the collective investment scheme for profits tax purposes, given the fact that the bond-issuer usually declares a trust over the bond proceeds and thereby acts as trustee on behalf of the bond-holders in practice.]

3.16.6 For the purposes of section 14A (charge on assessable profits from QDI) of IRO and section 26A (exclusion of certain profits from tax) of IRO –

(a) if the rights in an alternative bond under the qualified bond arrangement are transferable by delivery of the alternative bond, with or without endorsement, the alternative bond is to be regarded as an instrument specified in paragraph 3 of Part 1 of Schedule 6;

(b) the issue of an alternative bond under the qualified bond arrangement is to be regarded as a debt issue for the purpose of paragraph (a) of the definition of "debt instrument" in section 14A of IRO;

(c) if an alternative bond is for purposes of section 14A of IRO regarded as a debt instrument by virtue of paragraphs (a) and (b) above, the making of the redemption payment for the alternative bond is to be regarded as the redemption on maturity or presentment of a debt instrument;

[Remarks: This aims to extend the tax concession / exemption under the QDI scheme to cover eligible sukuk in order to provide a level playing field for eligible sukuk vis-à-vis conventional QDIs from the bond-holders' perspective.]

3.16.7 For the purposes of section 15(1)(j), (k) and (l) (sums received or accrued in respect of certificate of deposit are deemed to be trading receipts) of IRO –

(a) if the rights in an alternative bond under the qualified bond arrangement are transferable by delivery of the alternative bond, with or without endorsement, the alternative bond is to be regarded as a certificate of deposit; and

(b) the making of the redemption payment for the alternative bond is to be regarded as the redemption on maturity or presentment of a certificate of deposit;

[Remarks: This seeks to treat the alternative bonds, the rights in which are transferable by delivery, as certificates of deposit, so that the disposal gains before maturity and the premium / discount element received on maturity will be treated as trading receipts for profits tax purposes unless they can fall within the QDI scheme as described in paragraph 3.16.6 above. This tax treatment is similar to that of conventional bonds.]

3.16.8 Section 16(2)(f) (deduction of interest on debentures and instruments) of IRO applies to additional payments payable on alternative bonds under the qualified bond arrangement by the bond-issuer as if they were interest payable on debentures or instruments by the bond-issuer;

[Remarks: This seeks to accord coupon payments payable on sukuk the same tax treatment as interest payable on conventional bonds from the bond-issuer's perspective.]

3.16.9 Section 20AC (certain profits of non-resident persons exempt from tax) of IRO and item 1 of Schedule 16 apply as if alternative bonds issued under the qualified bond arrangement were bonds for the purposes of paragraph (a) of the definition of "securities" in that Schedule; and

[Remarks: This seeks to expand the list of specified transactions in Schedule 16 to cover sukuk for the purposes of exempting certain profits of non-residents from tax under section 20AC of IRO, and hence providing a level playing field between sukuk and conventional bonds.]

3.16.10 For the purposes of section 26A (exclusion of certain profits from tax) of IRO, the qualified bond arrangement is not to be regarded as a mutual fund, unit trust or similar investment scheme described in subsection (1A)(a) of that section.

[Remarks: This seeks to clarify that a qualified bond arrangement is not to be regarded as a mutual fund, unit trust or similar investment scheme for the purposes of section 26A of IRO so that the alternative bonds issued under a qualified bond arrangement can enjoy tax exemption under section 26A(1) if the relevant conditions are met.]

Qualified investment arrangement

3.17 We propose that a qualified investment arrangement be eligible for the special tax treatment along the following lines for the purposes of IRO –

3.17.1 The qualified investment arrangement is to be regarded as a debt arrangement;

3.17.2 The acquisition cost under the qualified investment arrangement is to be regarded as the money borrowed by the originator from the bond-issuer;

3.17.3 The investment return under the qualified investment arrangement is to be regarded as interest payable on the money borrowed by the originator from the bond-issuer;
[Remarks: This seeks to treat the investment return as interest payable on a debt arrangement for profits tax purposes.]

3.17.4 The bond-issuer is to be regarded as not having any legal or beneficial interest in the specified asset under the specified alternative bond scheme;
[Remarks: This is proposed for avoidance of doubt given the fact that the bond-issuer usually acts as trustee over the specified asset for the benefit of the bond-holders in practice.]

3.17.5 Section 16(2)(f)(iii) (interest payable on money borrowed

from an associated corporation is deductible if money borrowed arises entirely from proceeds of issue by the associated corporation of certain debentures or instruments) of IRO is to be applied as if –

(a) alternative bonds issued under the qualified bond arrangement were debentures or instruments; and

(b) the bond-issuer were an associated corporation of the originator as borrower.

[Remarks: This seeks to treat alternative bonds as debentures or instruments so that the current tax treatment under section 16(2)(f)(iii) concerning interest payable in respect of borrowings from an associated corporation which are entirely funded by the proceeds of listed debentures or bona fide debt instruments would apply to the investment return (which is economically equivalent to interest) payable by the originator to the bond-issuer under the qualified investment arrangement. There is a need to make clear that the bond-issuer is to be regarded as the associated corporation of the originator because in some cases the bond-issuer may be owned by an independent trustee instead for the purposes of reinforcing the bond-issuer's "orphan" status.]

3.17.6 In addition to the above, if the qualified investment arrangement in a specified alternative bond scheme does not involve the bond-issuer holding, as specified asset under the specified alternative bond scheme, an interest in a business undertaking that is entered into by the originator and the bond-issuer –

(a) any **specified asset transaction between the originator and the bond-issuer** under the qualified investment arrangement is to be disregarded. The specified asset transaction between the originator and the bond-issuer is proposed to include the following –

(i) Leaseback arrangement

- each acquisition referred to in paragraphs 3.4

and 3.5;

- each lease referred to in paragraphs 3.4 and 3.5;
- each disposal referred to in paragraphs 3.4 and 3.5;

(ii) Purchase and sale arrangement

- disposal referred to in paragraph 3.10.2;

(b) where any asset is acquired as specified asset under the qualified investment arrangement by the bond-issuer from a third party, the asset is to be regarded as acquired by the originator directly from the third party; and

(c) any income, expenditure, profits, gains or losses arising from or attributable to any asset as specified asset under the specified alternative bond scheme are to be treated as income, expenditure, profits, gains or losses (as the case requires) of the originator.
[Remarks: The originator is to be regarded as the owner of any asset as specified asset by virtue of paragraphs (a) and (b) above and hence any income, expenditure, profits, gains or losses arising from or attributable to the specified asset would belong to the originator for tax purposes. Particularly, the originator would be entitled to depreciation allowances associated with the specified asset, if applicable, as a result.]

3.17.7 However, if the qualified investment arrangement in a specified alternative bond scheme involves the bond-issuer holding, as specified asset under the specified alternative bond scheme, an interest in a business undertaking that is entered into by the originator and the bond-issuer –

(a) the business undertaking, the acquisition of the interest in the business undertaking as specified asset

by the bond-issuer and the disposal of that interest in favour of the originator, are to be disregarded;

(b) any **asset transaction between the originator and the business undertaking** under the qualified investment arrangement is to be disregarded. The asset transaction between the originator and the business undertaking for profits sharing arrangement are proposed to include the following –

(i) each acquisition referred to in paragraph 3.6.3(a);
(ii) each lease referred to in paragraph 3.6.3(b); and
(iii) each disposal referred to in paragraph 3.6.3(c);

(c) where any asset is acquired by the business undertaking from a third party, the asset is to be regarded as acquired by the originator directly from the third party;

(d) any other business activities carried on by the business undertaking during the specified term are to be treated as if the business activities were carried on by the originator directly; and
[Remarks: An example of other business activities is to engage in a property development project.]

(e) any income, expenditure, profits, gains or losses arising from or attributable to any asset held by the business undertaking or other business activities carried on by the business undertaking during the specified term of the specified alternative bond scheme are to be treated as income, expenditure, profits, gains or losses (as the case requires) of the originator.
[Remarks: The originator is to be regarded as the owner of any asset held by the business undertaking and carrying on any other business activities directly

by virtue of paragraphs (a) to (d) above and hence any associated income, expenditure, profits, gains or losses would belong to the originator for tax purposes. Particularly, the originator would be entitled to depreciation allowances associated with the asset, if applicable, as a result.]

3.18 In relation to the special tax treatment applicable to a qualified investment arrangement, we intend to explain how the special tax treatment is to be applied to each specified investment arrangement in the DIPNs for the sake of clarity.

Power to specify new asset transaction for special tax purpose by subsidiary legislation subject to negative vetting by LegCo

3.19 In order to cater for cases where new investment arrangement(s) is added as new specified investment arrangement(s) into the proposed special tax regime as described in paragraph 3.13 in the future, we propose to provide FS with the power to specify, by notice published in the Gazette (which will be subsidiary legislation subject to negative vetting by LegCo), any transaction as a specified asset transaction between the originator and the bond-issuer or an asset transaction between the originator and the business undertaking for the purposes of paragraphs 3.17.6(a) and 3.17.7(b) above.

Question 8

Do you agree that the special tax treatment in paragraphs 3.16 and 3.17 is sufficient to provide a level playing field for sukuk vis-à-vis their conventional counterparts in terms of tax liabilities? Please explain the reasons for your views.

E. Obligations of the originator and bond-issuer after the special tax treatment has been applied

3.20 If a person carrying on a trade, profession or business in Hong Kong has, or is to have, profits of the trade, profession or business assessed on the basis that an arrangement in a scheme (**alleged specified alternative bond scheme**) is a qualified bond arrangement or qualified investment arrangement in a specified alternative bond scheme and the person is the originator (**alleged originator**) or bond-issuer (**alleged bond-issuer**) under the alleged specified alternative bond scheme, we propose that –

3.20.1 Section 51C (business records to be kept) of IRO and section 51D (rent records to be kept) of IRO apply to the keeping of records relating to transactions, acts or operations relating to the scheme, and the arrangements in it, with the following modifications –

(a) the periods of 7 years referred to in sections 51C(1) and 51D(1) of IRO begin to run after the end of the specified term of the scheme (instead of after the completion of the transactions, acts or operations).

3.20.2 However, the proposed requirement on keeping of records relating to transactions, acts or operations relating to the bond arrangement in the alleged specified alternative bond scheme by the alleged bond-issuer ceases to apply if –

(a) under section 60 of IRO, modified as described in paragraph 3.28 below, one or more assessments or additional assessments have been made on the basis that the bond arrangement is treated as never having been a qualified bond arrangement in a specified alternative bond scheme; and

(b) the assessments and additional assessments have all become final and conclusive under section 70 of IRO.

3.20.3 Similarly, the proposed requirement on keeping of records relating to transactions, acts or operations relating to the

investment arrangement in the alleged specified alternative bond scheme by the alleged originator or alleged bond-issuer ceases to apply if –

(a) under section 60 of IRO, modified as described in paragraph 3.28 below, one or more assessments or additional assessments have been made on the basis that the investment arrangement is treated as never having been a qualified investment arrangement in a specified alternative bond scheme; and

(b) the assessments and additional assessments have all become final and conclusive under section 70 of IRO against the alleged originator or alleged bond-issuer (as the case requires).

[Remarks: With this proposed requirement, the originator and bond-issuer will be obliged to keep business and rent records once the special tax treatment has been applied. Normally, records are required to be kept for not less than 7 years after the completion of the relevant transactions. However, in view of tax avoidance concerns, we propose to require the relevant parties to keep records of the relevant transactions for not less than 7 years after the end of the specified term of the alternative bond scheme (which may be shortened if there is early redemption of sukuk or if the special tax treatment has been withdrawn during the specified term and the relevant assessment or additional assessment has become final and conclusive). Under the existing section 80 of IRO, any person who without reasonable excuse fails to observe the record-keeping requirement as described in section 51C or 51D commits an offence. The penalty for non-compliance with section 51C is a fine at level 6 (i.e. HK$100,000), while that for non-compliance with section 51D is a fine at level 3 (i.e. HK$10,000). In addition, any person who willfully with intent to evade tax prepares or maintains false books of accounts or records commits an offence under the existing section 82 of IRO and is liable for penalties specified in that section.]

F. Circumstances under which a qualified bond arrangement or a qualified investment arrangement will be disqualified

Bond arrangement

3.21 We propose that if a **bond arrangement ("BA") disqualifying event** occurs at any time in relation to the scheme, then the bond arrangement is to be treated as never having been a qualified bond arrangement, where –

3.21.1 BA disqualifying event means –

(a) the scheme is, at any time, not a specified alternative bond scheme; or

(b) although the scheme is a specified alternative bond scheme at all times –

(i) its bond arrangement, at any time, fails to comply with –

- the limit on return condition; or
- the bond arrangement as financial liability condition; or

(ii) the scheme, at any time, fails to comply with –

- the maximum term length condition; or
- the arrangements performed according to tenor condition.

3.22 Having regard to certain special circumstances, we propose that the CIR may disregard any non-compliance with the arrangements performed according to tenor condition by the specified alternative bond scheme if it is proved to the satisfaction of the CIR that –

(a) the non-compliance was constituted by a delay in disposing of the specified asset; and

(b) there was a reasonable excuse for the delay.

[Remarks: This relaxation seeks to cater for some special cases where there is a delay in disposal of the specified asset which is out of the control of the originator and bond-issuer.]

Investment arrangement

3.23 As far as the investment arrangement is concerned, we propose that if an **investment arrangement ("IA") disqualifying event** occurs at any time in relation to the scheme, then the investment arrangement is to be treated as never having been a qualified investment arrangement, where –

3.23.1 IA disqualifying event means –

(a) a BA disqualifying event;

(b) the scheme, at any time, fails to comply with –

(i) the bond-issuer as conduit condition; or

(ii) the diverse holding condition; or

(c) the investment arrangement of the scheme, at any time, fails to comply with the investment arrangement as financial liability condition.

[Remarks: The above suggests that non-compliance with any qualifying conditions for the bond arrangement will result in disqualification of both the bond arrangement and investment arrangement. However, if the non-compliance with qualifying conditions for the investment arrangement is not due to a BA disqualifying event, only the investment arrangement will be disqualified.]

3.24 Having regard to certain special circumstances, we propose that the CIR may disregard any non-compliance with the diverse holding condition by the specified alternative bond scheme if it is proved to the satisfaction of the CIR that, as soon as reasonably practicable after any specified holder (viz. the originator, the bond-issuer or any of their associates) became aware of the non-compliance, the aggregate of alternative bonds issued under the bond arrangement in the specified alternative bond scheme that were beneficially held by or were acquired with funds provided, directly or indirectly, by specified holders was lowered to 50% of the total alternative bonds issued under the bond arrangement, or below.

[Remarks: This relaxation seeks to cater for some special scenarios where the originator, the bond-issuer and/or their associates might hold more than 50% of the issue for a transitional period of time due to issuance arrangement or exercise of right to redemption by investors.]

Notification requirement

3.25 If a claim has been made that an arrangement in a scheme (**alleged specified alternative bond scheme**) is a qualified bond arrangement in a specified alternative bond scheme and is to be treated in accordance with paragraph 3.16 above, and that a person (**alleged bond-issuer**) is the bond-issuer of the alleged specified alternative bond scheme, and any BA disqualifying event as defined in paragraph 3.21.1 occurs in relation to the alleged specified alternative bond scheme, we propose that –

3.25.1 The alleged bond-issuer must inform the CIR, in writing, of the occurrence of the BA disqualifying event within 1 month after the event.

3.25.2 However, a BA disqualifying event in respect of an arrangement is not required to be informed if by reason of an earlier occurrence of a BA disqualifying event, an assessment or additional assessment has been made under section 60 of IRO, modified as described in paragraph 3.28 below, on the basis that the arrangement is treated as never having been a qualified bond arrangement in a specified alternative bond scheme; and the assessment or additional assessment has become final and conclusive under section 70 of IRO.

3.26 Similarly, if a claim has been made that an arrangement in a scheme (**alleged specified alternative bond scheme**) is a qualified investment arrangement in a specified alternative bond scheme and is to be treated in accordance with paragraph 3.17 above, and that a person is the originator or bond-issuer of the alleged specified

alternative bond scheme, and any IA disqualifying event as defined in paragraph 3.23.1 occurs in relation to the alleged specified alternative bond scheme, we propose that –

3.26.1 The person must inform the CIR, in writing, of the occurrence of the IA disqualifying event within 1 month after the event.

3.26.2 Nevertheless, an IA disqualifying event in respect of an arrangement is not required to be informed if by reason of an earlier occurrence of an IA disqualifying event, an assessment or additional assessment has been made under section 60 of IRO, modified as described in paragraph 3.28 below, on the basis that the arrangement is treated as never having been a qualified investment arrangement in a specified alternative bond scheme; and the assessment or additional assessment has become final and conclusive under section 70 of IRO.

[Remarks: This means that once a claim on special tax treatment has been made, if any disqualifying events subsequently occur, the bond-issuer is required to notify the CIR of those relating to the BA disqualifying events while the bond-issuer and originator are required to notify the CIR of those relating to the IA disqualifying events. This notification requirement on an arrangement will no longer apply if the special tax treatment for that arrangement is withdrawn and the relevant assessment or additional assessment has become final and conclusive.]

3.27 If any person who without reasonable excuse fails to observe the notification requirement in paragraph 3.25 or 3.26 above, we propose that –

3.27.1 Section 80 (penalties for failure to make returns, making incorrect returns, etc.) of IRO applies as if references in that section to a failure to comply with section 51(2) of IRO included a failure to comply with the notification requirement referred to in paragraph 3.25 or 3.26;

[Remarks: This suggests that any person who without reasonable excuse fails to observe the proposed notification requirement commits an offence and is liable on conviction to a fine at level 3 (i.e. HK$10,000) and a further fine of treble the amount of tax which has been undercharged in consequence of a failure to comply with the proposed notification requirement, or which would have been undercharged if such failure had not been detected.]

3.27.2 Section 82A (additional tax in certain cases) of IRO applies as if references in that section to a failure to comply with section 51(2) of IRO included a failure to comply with the notification requirement referred to in paragraph 3.25 or 3.26.

[Remarks: This suggests that if no prosecution under section 80(2) or 82(1) of IRO has been instituted in respect of the same facts, the person shall be liable to be assessed to additional tax of an amount not exceeding treble the amount of tax which has been undercharged in consequence of a failure to comply with the proposed notification requirement, or which would have been undercharged if such failure had not been detected. Such additional tax shall be payable in addition to any amount of tax payable under an assessment or additional assessment under section 60 of IRO, modified as described in paragraph 3.28 below.]

G. Consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement

3.28 If, in respect of any person (**specified person**) in respect of any year of assessment (**specified year of assessment**), **a former qualified bond arrangement has become disqualified**[19] or **a former qualified investment arrangement has become disqualified**[20], we propose that –

3.28.1 section 60 (additional assessments) of IRO applies to the making of assessment or additional assessment for a specified year of assessment with modifications, namely, each of the following periods –

(a) 6 years referred to in section 60(1) of IRO;

(b) 10 years referred to in paragraph (b) of the proviso to section 60(1) of IRO;

(c) 6 years referred to in section 60(2) of IRO,

begins to run after the expiration of the year of disqualification (instead of after the expiration of the specified year of assessment).

3.28.2 section 79 (tax paid in excess to be refunded) of IRO applies to an amount of tax that is found to be paid in excess by a specified person for a specified year of assessment, with the following modifications –

(a) the period of 6 years referred to in section 79(1) of IRO begins to run after the end of the year of disqualification (instead of after the end of the specified year of assessment); and

(b) if an assessor makes an assessment or additional assessment under section 60 of IRO on that specified person for any specified year of assessment, and it

[19] This means that the arrangement has been a qualified bond arrangement in a specified alternative bond scheme, but by reason of a BA disqualifying event as defined in paragraph 3.21.1 that subsequently occurs, the arrangement is under paragraph 3.21 to be treated as never having been a qualified bond arrangement in a specified alternative bond scheme.

[20] This means that the arrangement has been a qualified investment arrangement in a specified alternative bond scheme, but by reason of an IA disqualifying event as defined in paragraph 3.23.1 that subsequently occurs, the arrangement is under paragraph 3.23 to be treated as never having been a qualified investment arrangement in a specified alternative bond scheme.

appears to the assessor that an amount of tax has been paid in excess by that specified person for another specified year of assessment, then, even in the absence of a claim in writing being made under section 79 of IRO for the refund, a refund of that amount of tax paid in excess may be made under section 79 of IRO, or that amount refundable may be set off against any amount payable under the assessment or additional assessment made under section 60 of IRO in respect of any specified year of assessment.

3.28.3 For the purposes of the above, **year of disqualification** means –

(a) in the case of a former qualified bond arrangement becoming disqualified, the year of assessment in which

(i) any BA disqualifying event as defined in paragraph 3.21.1 occurs; or

(ii) if there are 2 or more BA disqualifying events, the earliest BA disqualifying event occurs; or

(b) in the case of a former qualified investment arrangement becoming disqualified, the year of assessment in which

(i) any IA disqualifying event as defined in paragraph 3.23.1 occurs; or

(ii) if there are 2 or more IA disqualifying events, the earliest IA disqualifying event occurs.

[Remarks: With the proposed amendments above, the 6-year limitation period for tax recovery and refund will begin to run after the expiration of the year of disqualification (instead of after the expiration of the specified year of assessment) for the bond arrangement and investment arrangement in an alternative bond scheme. There is a need for such amendment because the existing provisions cannot cater for those sukuk with tenor longer than 6 years. We consider it appropriate to use the year of disqualification as the starting point for counting the limitation

period as the need for tax recovery or refund is triggered by the disqualifying event.]

3.29 We also propose that the provisions of IRO as to the notice of assessment, appeal and other proceedings that apply to an assessment, additional assessment or reassessment made under section 60 or 79 (as the case requires) of IRO and to any tax charged under it are to apply to an assessment, additional assessment or reassessment made under section 60 or 79 (as the case requires) of IRO as modified in paragraph 3.28 above, and to any tax charged accordingly.

3.30 However, where an assessment, additional assessment or reassessment has been so made in respect of more than one specified year of assessment by reason of a former qualified bond arrangement or former qualified investment arrangement having become disqualified, and a specified person makes an objection under section 64 of IRO against an assessment, additional assessment or reassessment in respect of any of those specified years of assessment, the objection is to be regarded as being made against all specified years of assessment in respect of which an assessment, additional assessment or reassessment has been made by that reason.

H. Key miscellaneous amendments

3.31 For the purposes of the diverse holding condition in paragraph 3.15.15, we propose to update the definitions of "associate" and "associated corporation" in section 14A (charge on assessable profits from QDI) of IRO by reference to section 16EC (deduction under section 16E or 16EA not allowable under certain circumstances) of IRO, which is the latest version of "associate" under IRO, along the following lines –

3.31.1 **associate**, in relation to a person (**first-mentioned person**), means—

(a) if the first-mentioned person is a natural person—

(i) a relative of the first-mentioned person;

(ii) a partner of the first-mentioned person;

(iii) if a partner of the first-mentioned person is a natural person, a relative of that partner;

(iv) a partnership of which the first-mentioned person is a partner;

(v) a corporation controlled by—

(A) the first-mentioned person;

(B) a relative of the first-mentioned person;

(C) a partner of the first-mentioned person;

(D) if a partner of the first-mentioned person is a natural person, a relative of that partner; or

(E) a partnership of which the first-mentioned person is a partner; or

(vi) a director or principal officer of a corporation referred to in subparagraph (v);

(b) if the first-mentioned person is a corporation—

(i) an associated corporation;

(ii) a person who controls the first-mentioned person;

(iii) a partner of a person who controls the first-mentioned person;

(iv) if a person who controls the first-mentioned person is a natural person, a relative of that person;

(v) if a partner referred to in subparagraph (iii) is a natural person, a relative of that partner;

(vi) a director or principal officer of the first-mentioned person or of an associated corporation;

(vii) a relative of a director or principal officer referred to in subparagraph (vi);

(viii) a partner of the first-mentioned person;

(ix) if a partner of the first-mentioned person is a natural person, a relative of that partner; or

(x) a partnership of which the first-mentioned person is a partner; or

(c) if the first-mentioned person is a partnership—

(i) a partner of the first-mentioned person;

(ii) if a partner of the first-mentioned person is a natural person, a relative of that partner;

(iii) a partnership of which the first-mentioned person is a partner;

(iv) if a partner of the first-mentioned person is a partnership, a partner (**Partner A**) of that partnership or a partner (**Partner B**) with that partnership in any other partnership;

(v) if Partner A is a partnership, a partner of Partner A;

(vi) if Partner B is a partnership, a partner of Partner B;

(vii) if a partner of, or with, or in any of the partnerships referred to in subparagraph (iv), (v) or (vi) is a natural person, a relative of that partner;

(viii) a corporation controlled by—

(A) the first-mentioned person;

(B) a partner of the first-mentioned person;

(C) if a partner of the first-mentioned person is a natural person, a relative of that partner; or

(D) a partnership of which the first- mentioned person is a partner;

(ix) a director or principal officer of a corporation referred to in subparagraph (viii); or

(x) a corporation of which a partner of the first-mentioned person is a director or principal officer.

3.31.2 **associated corporation**, in relation to a person (**first-mentioned person**), means—

(a) a corporation over which the first-mentioned person has control;

(b) a corporation which has control over the first-mentioned person; or

(c) a corporation which is under the control of the same person as is the first-mentioned person.

3.31.3 For the purposes of paragraph (c) of the definition of associated corporation in the preceding paragraph, a corporation is not regarded as being under the control of the same person as is the first-mentioned person by reason only that—

(a) both the corporation and the first-mentioned person are wholly owned by—
  (i) the central government of the same country; or
  (ii) the Government of Hong Kong;

(b) more than 50% of the voting power in the corporation and more than 50% of the voting power in the first-mentioned person are held or controlled by—
  (i) one or more than one corporation which is established and wholly owned by the central government of the same country or the Government of Hong Kong for the purpose of carrying on the business of investment (**government investment vehicle**); or
  (ii) a wholly owned subsidiary of a government investment vehicle; or

(c) more than 50% of the voting power in the corporation is held or controlled by a corporation wholly owned

by the central government of the same country or the Government of Hong Kong (**government enterprise**) and more than 50% of the voting power in the first-mentioned person is held or controlled by another government enterprise

3.31.4 Paragraph 3.31.3 does not apply if the first-mentioned person is the issuer of a debt instrument issued before the date of commencement of the Inland Revenue (Amendment) Ordinance 2011 (4 of 2011).

[Remarks: As compared with the existing section 16EC of IRO, our proposed definition of "associate" in paragraph 3.33.1 contains additional items in its (b)(x) and (c)(ii) and (iii), for further improvement, viz. "a partnership of which the first-mentioned person is a partner" is added under the scenario where the first-mentioned person is a corporation in paragraph 3.31.1(b), and "if a partner of the first-mentioned person is a natural person, a relative of that partner" and "a partnership of which the first-mentioned person is a partner" are added under the scenario where the first-mentioned person is a partnership in paragraph 3.31.1(c).]

3.32 In addition, taking opportunity of this legislative exercise, we also propose to repeal the existing definitions of "associate" and "associated corporation" in section 16 (ascertainment of chargeable profits) of IRO and replace them with those updated definitions in section 14A as proposed in paragraph 3.31 above. This would help align the definition of "associate" in section 16(3) with that in section 14A(4) and the diverse holding condition as proposed in paragraph 3.15.15, which are all related and applicable to debt instruments.

Question 9

Do you have any other views or comments on the proposed amendments to IRO?

PART II: DETAILS OF THE MAJOR PROPOSED AMENDMENTS TO SDO

A. 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

3.33 Under our proposal, SDO will adopt the same concepts of alternative bond scheme, bond arrangement and investment arrangement as those proposed to be adopted in IRO.

Qualified bond arrangement

3.34 In relation to a bond arrangement, similar to IRO, we propose that it must be a **qualified bond arrangement** in order for an instrument executed in respect of the transactions of the alternative bonds issued under it to be eligible for stamp duty treatment similar to conventional bonds under SDO. For a bond arrangement in an alternative bond scheme (**scheme**) to be a qualified bond arrangement at any time (**material time**), we propose that certain qualifying conditions along the following lines must be complied with –

3.34.1 The scheme is and, from the commencement of the specified term up to the material time, has always been **a specified alternative bond scheme**;

3.34.2 The bond arrangement complies and, from the commencement of the specified term up to the material time, has always complied with –

(a) **the limit on return condition**; and

(b) **the bond arrangement as financial liability condition**; and

3.34.3 The scheme complies and, from the commencement of the specified term up to the material time, has always complied

with –

(a) **the maximum term length condition**; and

(b) **the arrangements performed according to tenor condition**.

[Remarks: The qualifying conditions for a bond arrangement under SDO are essentially the same as those under IRO.]

3.35 Under our proposal, the qualifying conditions mentioned in paragraph 3.34 for the purposes of SDO have the same meaning as they have in paragraph 3.14. However, for the purposes of the limit on return condition, paragraph 3.14.5 is to be read as if references to the CIR in that paragraph were references to the CSR.

Qualified investment arrangement

3.36 Similarly, for an investment arrangement in a scheme to be a **qualified investment arrangement** at any time (**material time**), we propose that certain qualifying conditions along the following lines must be complied with –

3.36.1 The scheme and the bond arrangement are and, from the commencement of the specified term up to the material time, have always been a specified alternative bond scheme and **a qualified bond arrangement** respectively;

3.36.2 The scheme complies and, from the commencement of the specified term up to the material time, has always complied with –

(a) **the bond-issuer as conduit condition**; and

(b) **the diverse holding condition**; and

3.36.3 The investment arrangement complies and, from the commencement of the specified term up to the material time, has always complied with **the investment arrangement as financial liability condition**.

[Remarks: The qualifying conditions for an investment arrangement under SDO are essentially the same as those under IRO.]

3.37 Under our proposal, the qualifying conditions mentioned in paragraph 3.36 for the purposes of SDO have the same meaning as they have in paragraph 3.15. Further, paragraphs 3.15.7 to 3.15.14 relating to the calculation of the investment return under a specified investment arrangement apply for the purposes of the bond-issuer as conduit condition just as those paragraphs apply to the calculation of the investment return under a specified investment arrangement for the purposes of IRO. However, references to the CIR in those paragraphs are to be read as references to the CSR.

3.38 If an investment arrangement is a qualified investment arrangement on meeting the conditions proposed in paragraph 3.36, an instrument that is executed pursuant to it enjoys stamp duty relief under SDO if requirements along the following lines are complied with –

3.38.1 It must be shown to the satisfaction of the CSR that –

(a) the instrument is executed pursuant to a **qualified investment arrangement** in a specified alternative bond scheme either –

(i) to effect a transaction that is a **specified asset transaction between the originator and the bond-issuer**[21] or an **asset transaction between the originator and the business undertaking**[22] under that qualified investment arrangement (**IA transaction**); or

(ii) as an agreement for an IA transaction; or

(b) the instrument is required by SDO to be made and executed for effecting an IA transaction.

[Remarks: In order to enable the CSR to determine if this requirement is met, any person who claims the stamp duty

[21] The term is to have the same meaning as defined in paragraph 3.17.6(a).
[22] The term is to have the same meaning as defined in paragraph 3.17.7(b)

relief would need to furnish a copy of the relevant transaction documents / offering circulars and provide undertakings / representations where appropriate. The details will be elaborated in the SOIPNs for the sake of clarity.]

3.38.2 Security to the satisfaction of the CSR must be given in respect of the payment of the amount of stamp duty and other amounts that would, apart from the relief mentioned in paragraph 3.40, have to be paid under SDO in respect of the instrument.

[Remarks:

- This security requirement is an additional requirement under SDO in respect of an investment arrangement in a specified alternative bond scheme as compared with IRO, and seeks to reduce the risk of irrecoverable duty in the event of withdrawal of stamp duty relief.
- Specifically, given that the parties involved in the investment arrangement, including the originator and bond-issuer, may not be locally incorporated, if the stamp duty relief is withdrawn, it may not be possible to recover the stamp duty due as these parties are not in our jurisdiction and the asset may have been transferred to other party without notice. This will create a big loophole for avoidance of duty and give rise to potential for abuse. Therefore, we consider it necessary to request security in order to plug this loophole. As a matter of fact, we note that there is also a similar requirement under the UK legislation[23].
- For the sake of clarity, we will provide guidance on the type and amount of security in the SOIPNs. Our initial thinking is that the type of acceptable security may include a registered first legal charge on the underlying asset or a bank guarantee in favour of the CSR, while the amount of security demanded may cover the stamp duty that would otherwise be payable as well as any possible penalty related thereto. Our

[23] Finance Act 2009 (2009 c 10), Schedule 61, paragraph 5(6).

initial thinking is that the security should be provided within 60 days after the date of execution of the relevant instruments.

- Stamp duty relief will not be granted on an instrument if security in respect of that instrument cannot be provided to the satisfaction of the CSR.]

Question 10

Do you agree with the qualifying conditions and requirements proposed for the bond arrangement and investment arrangement under SDO? Please explain the reasons for your views.

B. Stamp duty treatment / relief applicable to an instrument executed in relation to a qualified bond arrangement and a qualified investment arrangement that can meet the conditions and requirements

Qualified bond arrangement

3.39 In relation to a qualified bond arrangement, we propose that for the purposes of SDO –

3.39.1 The bond-holders under a qualified bond arrangement in a specified alternative bond scheme are to be regarded as not having any legal or beneficial interest in the specified asset under the specified alternative bond scheme; and

[Remarks: In Islamic context, sukuk certificates evidence the holders' ownership in the underlying asset. There is thus uncertainty as to whether transfer of the sukuk certificates would amount to transfer of the underlying asset. This proposed provision seeks to clarify that transfer of an alternative bond issued under a qualified bond arrangement of a specified alternative bond scheme would not be treated as transfer of the specified asset for stamp duty purposes.]

3.39.2 An alternative bond issued under a qualified bond arrangement is to be regarded as a bond to which neither paragraph (b) nor (c) of the definition of "loan capital" in section 2 of SDO applies.

[Remarks:

- If a bond arrangement can satisfy the relevant qualifying conditions, it suggests that the alternative bond issued under that bond arrangement is economically equivalent to a bond. We therefore consider it appropriate to treat the alternative bond issued under a qualified bond arrangement of a specified alternative bond scheme as a bond for stamp duty purposes to bring it at par with conventional bonds in terms of stamp duty treatment.
- As a result of this proposed provision, transfer of an alternative bond will not be subject to stamp duty

charges in most cases, as it will either (i) fall within the meaning of "loan capital" in section 2 of SDO (unless the alternative bond carries a right of conversion into stock or to the acquisition of any stock, i.e. paragraph (a) of the definition of "loan capital"), or (ii) fall within the exclusion in the definition of "stock" in section 2 of SDO if the alternative bond is denominated in foreign currency, irrespective of whether it carries a conversion right into stock or not.

- A qualified bond arrangement by definition suggests that it has complied with the limit on return condition and the bond arrangement as financial liability condition. So, any alternative bond issued under a qualified bond arrangement would not fall within paragraph (b) or (c) of the definition of "loan capital". This proposed provision is intended to spell it out for clarity.]

Qualified investment arrangement

3.40 For an investment arrangement that can meet the requirements mentioned in paragraph 3.38 above, we propose that –

3.40.1 Stamp duty under heads 1(1), 1(1AA), 1(1A), 1(1B), 1(2), 2(1), 2(3), and 2(4) in the First Schedule, and under section 29D(2)(a), of SDO is not chargeable on the instruments referred to in paragraph 3.38.1.

[Remarks: This seeks to grant stamp duty relief on instruments executed in relation to transactions of Hong Kong immovable property or Hong Kong stock between the originator and the bond-issuer or between the originator and the business undertaking under a qualified investment arrangement. Any such transaction arising from a replacement of asset under the leaseback arrangement and the profits sharing arrangement is also covered. This treatment will help put sukuk on an equal footing with conventional bonds which do not normally require the

transfer or lease of asset.]

3.41 We propose that mandatory adjudication be required for each instrument to which paragraph 3.40.1 applies. Such instrument is not duly stamped unless –

(a) it is stamped with the stamp duty with which it would, but for the relief described in paragraph 3.40, be chargeable; or

(b) it has, in accordance with section 13 of SDO, been stamped with a particular stamp or by way of a stamp certificate, denoting either that it is not chargeable with any stamp duty or that it is duly stamped.

[Remarks: This proposed requirement is modeled on the existing sections 44(3) and 45(3) of SDO which respectively require mandatory adjudication before granting relief in case of gift to exempted institution and conveyance from one associated body corporate to another.]

3.42 In this connection, as with other waivers of fee for mandatory adjudications under section 13(1B) of SDO, we also propose that no fee is to be charged for mandatory adjudication on instruments to which paragraph 3.40.1 applies.

Question 11

Do you agree that the stamp duty treatment / relief in paragraphs 3.39 and 3.40 is sufficient to provide a level playing field for sukuk vis-à-vis their conventional counterparts in terms of stamp duty liabilities? Please explain the reasons for your views.

C. Obligations of the originator and bond-issuer after the stamp duty relief has been granted

Qualified investment arrangement

3.43 If relief is granted, as described in paragraph 3.40, in respect of any instrument executed in relation to an arrangement (**alleged qualified investment arrangement**) in a scheme (**alleged specified alternative bond scheme**) as a qualified investment arrangement in a specified alternative bond scheme, we propose that –

3.43.1 Each person who is granted relief as described in paragraph 3.40 as the originator or the bond-issuer under the alleged qualified investment arrangement in the alleged specified alternative bond scheme –

(a) must keep proper and sufficient books and records in the English or Chinese language of transactions, acts, operations to which the alleged specified alternative bond scheme, or any arrangement in it, relates so as to enable determinations under SDO to be made; and

(b) must retain the books and records for a period of not less than 7 years after the end of the specified term of the alleged specified alternative bond scheme.

3.43.2 The preceding paragraph does not propose to require the keeping by a person of –

(a) any books or records that the CSR has specified as books or records that need not be kept by the person; or

(b) any books or records of a body corporate that has ceased to exist.

3.43.3 For the purposes of making a determination under SDO, the CSR –

(a) may give notice in writing to each person who is granted relief as described in paragraph 3.40 as the originator or the bond-issuer under an alleged

qualified investment arrangement in an alleged specified alternative bond scheme, requiring the person –

(i) to furnish a return within a reasonable time stated in the notice; or

(ii) to furnish returns at any time intervals stated in the notice; and

(b) may specify in the notice –

(i) the information relating to the alleged specified alternative bond scheme, or any arrangement in it, to be contained in the return; and

(ii) the form in which the return is to be furnished.

3.43.4 Without limiting paragraph 3.43.1 or 3.43.3, a determination under SDO includes a determination as to –

(a) whether to grant or withdraw, as described in paragraph 3.40 or 3.49, relief in respect of an instrument executed in relation to the alleged qualified investment arrangement in an alleged specified alternative bond scheme; and

(b) whether an IA disqualifying event[24] has occurred in relation to an alleged specified alternative bond scheme.

[Remarks:

- The proposed record-keeping and return-furnishing requirements will only apply to the case where stamp duty relief has been granted on any instrument executed in relation to a qualified investment arrangement. The aim is to ensure ongoing compliance of the qualifying conditions in the remainder of the specified term.
- For the sake of clarity, the form and information required for the records and returns will be specified in the SOIPNs. Our initial thinking is that the records should contain such particulars as movement of the

[24] This term is defined in paragraph 3.45.1.

underlying asset under the investment arrangement and holding of the alternative bonds under the bond arrangement. The proposed 7-year record-keeping period is in line with that proposed to be required under IRO in paragraph 3.20 above. At the same time, the originator and bond-issuer are expected to furnish returns on a semi-annual basis to declare whether any IA disqualifying event has occurred or not during the reporting period.]

3.43.5 Under our proposal, a person who fails to comply with the requirements described in paragraph 3.43.1, or a requirement in a notice given as described in paragraph 3.43.3, is to incur a penalty at level 2[25] which is recoverable by the CSR as a civil debt due to the Government.

[Remarks: This is modeled on the existing section 19(15) of SDO relating to similar failure caused by a borrower under a stock borrowing and lending agreement. With the proposed provision, any person who fails to keep such books and records or furnish such returns as required by the CSR will be subject to a civil penalty at level 2 (i.e. HK$5,000).]

3.43.6 A person who, with intent to defraud the Government of any stamp duty, causes or allows –

(a) an entry to be made in the books and records kept as described in paragraph 3.43.1; or

(b) any particular to be furnished in a return made as described in paragraph 3.43.3,

that is false or misleading in a material respect, commits an offence and is liable for the fine and punishment specified in section 60 of SDO.

[Remarks: This is largely modeled on section 19(14) of SDO relating to similar offence committed by a borrower under a stock borrowing and lending agreement. Pursuant

[25] The amount of penalty is equal to the amount of fine shown for that level in Schedule 8 of the Criminal Procedure Ordinance (Cap. 221).

to section 60 (punishment for offences) of SDO, any person who commits or attempts to commit an offence under SDO shall be liable to a fine at level 6 (i.e. HK$100,000) and to imprisonment for 1 year.]

3.43.7 Nevertheless, the provisions proposed in paragraphs 3.43.1 to 3.43.6 cease to apply to a person in relation to an alleged qualified investment arrangement in an alleged specified alternative bond scheme if, for each instrument executed in relation to the alleged qualified investment arrangement in respect of which relief had been granted as described in paragraph 3.40 to the person as the originator or bond-issuer –

(a) the relief has already been withdrawn;

(b) an assessment of the stamp duty payable has been made as described in paragraph 3.51 or 3.52; and

(c) either –

(i) the assessment has become final and conclusive as described in paragraph 3.53; or

(ii) the withdrawal of the relief has been confirmed by the court on appeal.

[Remarks: This seeks to make clear that the proposed record-keeping and return-furnishing requirements will no longer apply to the originator and/or bond-issuer if the stamp duty relief granted to the instruments executed in relation to an alleged qualified investment arrangement has been withdrawn and the relevant assessment has become final and conclusive.]

D. Circumstances under which a qualified bond arrangement or a qualified investment arrangement will be disqualified

Bond arrangement

3.44 Under our proposal, a bond arrangement is no longer a qualified bond arrangement if any of the qualifying conditions as proposed in paragraph 3.34 is not met.

Investment arrangement

3.45 In respect of the investment arrangement, we propose that if an **IA disqualifying event** occurs at any time in relation to the scheme, then the investment arrangement is to be treated as never having been a qualified investment arrangement. For this purpose –

3.45.1 IA disqualifying event means –

(a) the scheme is, at any time, not a specified alternative bond scheme; or

(b) although the scheme is a specified alternative bond scheme at all times –

(i) its bond arrangement, at any time, fails to comply with –

- the limit on return condition; or
- the bond arrangement as financial liability condition; or

(ii) the scheme, at any time, fails to comply with –

- the maximum term length condition;
- the arrangements performed according to tenor condition;
- the bond-issuer as conduit condition; or
- the diverse holding condition; or

(iii) its investment arrangement, at any time, fails to comply with the investment arrangement as financial liability condition.

3.46 Having regard to certain special circumstances, similar to IRO, we

propose that –

3.46.1 The CSR may disregard any non-compliance with the arrangements performed according to tenor condition by the specified alternative bond scheme if it is proved to the satisfaction of the CSR that –

(a) the non-compliance was constituted by a delay in disposing of the specified asset; and

(b) there was a reasonable excuse for the delay.

3.46.2 The CSR may disregard any non-compliance with the diverse holding condition by the specified alternative bond scheme if it is proved to the satisfaction of the CSR that, as soon as reasonably practicable after any specified holder (viz. the originator, the bond-issuer or any of their associates) became aware of the non-compliance, the aggregate of alternative bonds issued under the bond arrangement in the specified alternative bond scheme that were beneficially held by or were acquired with funds provided, directly or indirectly, by specified holders was lowered to 50% of the total alternative bonds issued under the bond arrangement, or below.

Notification requirement

3.47 We propose that if –

3.47.1 a claim for relief from stamp duty has been made, as described in paragraph 3.40, in respect of any instrument purporting –

(a) to have been executed to effect an IA transaction[26] under an arrangement (**alleged qualified investment arrangement**) in a scheme (**alleged specified alternative bond scheme**); or

(b) to have been executed as an agreement for an IA transaction; or

[26] Defined in paragraph 3.38.1.

(c) to have, as required by SDO, been made and executed for effecting an IA transaction; and

3.47.2 any persons purport to be the originator and bond-issuer of the alleged specified alternative bond scheme (**alleged originator** and **alleged bond-issuer**); and

3.47.3 any IA disqualifying event occurs in relation to the alleged specified alternative bond scheme, then

3.47.4 the alleged originator and alleged bond-issuer of the alleged specified alternative bond scheme must inform the CSR, in writing, of the IA disqualifying event within 30 days after the event.

[Remarks: This proposed notification obligation will arise once the originator and/or the bond-issuer has made a claim for stamp duty relief under an investment arrangement. The proposed notification period is modeled on the existing section 45(5A)(a) of SDO relating to similar notification obligation for relief granted in case of conveyance from one associated body corporate to another.]

3.47.5 However, an occurrence of an IA disqualifying event in relation to the alleged specified alternative bond scheme is not required to be notified if –

(a) by reason of an earlier occurrence of an IA disqualifying event in relation to the alleged specified alternative bond scheme, relief granted as described in paragraph 3.40 in respect of an instrument executed in relation to the alleged qualified investment arrangement in the alleged specified alternative bond scheme has already been withdrawn and an assessment of the stamp duty payable has been made as described in paragraph 3.51 or 3.52 below; and

(b) the assessment has become final and conclusive as described in paragraph 3.53 or the withdrawal of the

relief has been confirmed by the court on appeal.

3.47.6 Under our proposal, any person who fails to comply with the notification requirement as described in paragraph 3.47.4 incurs a penalty at level 2[27] which is recoverable by the CSR as civil debt due to the Government.

[Remarks: This is modeled on the existing section 45(7) of SDO relating to penalty on similar failure caused by the transferor and transferee in case they cease to be associated within 2 years after the date of execution of the instrument. With this proposed provision, any person who fails to observe the notification requirement is subject to a civil penalty at level 2 (i.e. HK$5,000).]

[27] The amount of penalty is equal to the amount of fine shown for that level in Schedule 8 of the Criminal Procedure Ordinance (Cap. 221).

E. Consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement

Bond arrangement

3.48 Under our proposal, the stamp duty treatment proposed in paragraph 3.39 will cease to apply to a bond arrangement if the bond arrangement is no longer a qualified bond arrangement. Put simply, an instrument executed in respect of the transactions of the alternative bonds issued under the bond arrangement is no longer eligible for stamp duty treatment similar to conventional bonds under SDO.

Investment arrangement

3.49 In relation to an investment arrangement, if paragraphs 3.47.1 to 3.47.3 apply and any relief from stamp duty has been granted by the CSR as described in paragraph 3.40 in respect of any instrument executed in relation to the alleged qualified investment arrangement, then subject to section 13(6) of SDO (i.e. the instrument is still admissible in evidence and available for all purposes), we propose that the relief is deemed to be withdrawn and

3.49.1 the parties to the instrument are liable or jointly and severally liable (as the case may be) to pay an amount to the CSR, by way of stamp duty –

(a) within 30 days after the IA disqualifying event; or

(b) if there are 2 or more IA disqualifying events, within 30 days after the earliest IA disqualifying event; and

3.49.2 the amount of the stamp duty is equal to the stamp duty which would have been chargeable on the instrument as if no relief from stamp duty had been granted by the CSR as described in paragraph 3.40.

[Remarks: The proposed provision above is largely modeled on

the existing section 45(5A)(c) of SDO relating to withdrawal of relief granted in case of conveyance from one associated body corporate to another. Given that several qualifying conditions have to be complied with, for avoidance of doubt, if there are two or more IA disqualifying events, the parties to the instrument shall be liable to the stamp duty from the date on which the earliest IA disqualifying event occurs.]

3.50 If the amount referred to in paragraph 3.49 is not paid within the 30 days, we propose that –

3.50.1 the parties to the instrument are liable or jointly and severally liable (as the case requires) to a penalty; and

3.50.2 the amount of the penalty payable after a lapse of time after the 30 days is the same as that calculated under section 9 in respect of an instrument chargeable with stamp duty of the amount referred to in paragraph 3.49 that –

(a) is not stamped before or within the time for stamping; and

(b) is stamped after the lapse of the same period of time after the time for stamping it.

[Remarks: The above is largely modeled on section 45(5A)(d) of SDO relating to penalty on similar failure of the transferor and transferee to pay the stamp duty to the CSR within a time limit. Specifically, under section 9 of SDO, if the instrument is stamped upon payment of the stamp duty chargeable not later than 1 month after the time for stamping, the penalty shall be double the amount of the stamp duty; if the instrument is so stamped later than 1 month but not later than 2 months after the time for stamping, the penalty shall be 4 times the amount of the stamp duty; and in any other case, the penalty shall be 10 times the amount of the stamp duty.]

3.50.3 the CSR may remit the whole or any part of any penalty payable as described in the preceding paragraph.

3.51 We propose that the CSR may make an assessment of the stamp duty that would have been chargeable on an instrument, as referred to in paragraph 3.49, on any person who is liable for the stamp duty and may serve on any person who is liable for the stamp duty a notice of the assessment by post within 7 days from the date on which the assessment is made.

3.52 If required by any person liable for stamp duty that would have been chargeable on an instrument as referred to in paragraph 3.49, we propose that the CSR must make an assessment of the stamp duty that would have been chargeable on the instrument and must serve on the person a notice of the assessment by post within 7 days from the date on which the assessment is made.

[Remarks: The proposed provisions in the two paragraphs above seek to empower the CSR to make and issue assessment of the stamp duty so as to put in place an appeal mechanism. Specifically, in case the originator and bond-issuer are aggrieved by the withdrawal of stamp duty relief, they can lodge an appeal to the court against the assessment of the CSR. The provisions are partly modeled on the existing section 13(8) of SDO, which allows the CSR to serve a notice of stamp duty assessment on any person who is liable for stamping an instrument, no matter who initiated the adjudication under section 13(1) of SDO.]

3.53 We propose that an assessment referred to in paragraph 3.51 or 3.52 is, after the expiration of a period of 1 month from the date on which the assessment is made, final and conclusive for all purposes as against the person, except if and to the extent that an appeal made against it under section 14 of SDO succeeds.
[Remarks: This is partly modeled on the existing section 13(8) of SDO. It makes clear that an assessment made under paragraph 3.51 or 3.52 will be conclusive for all purposes under SDO, including recovery of duty as a civil debt under section 4(3) of SDO, unless there is a successful appeal under section 14 of SDO.]

3.54 If, within a period of 1 month from the date on which an assessment is made, it appears to the CSR that the amount of the

stamp duty so assessed is excessive, we propose that the CSR may cancel the assessment and make another assessment instead as the CSR may deem proper, and any reference in SDO to an assessment is to be construed as including a reference to an assessment so made instead.

[Remarks: This is modeled on the existing section 13(9) of SDO. While having made an assessment, the CSR is allowed to make another assessment of a lesser amount in place of the original assessment within one month's time. This provides an alternative remedy for the aggrieved party without the need to lodge a formal appeal to the court under section 14 of SDO.]

3.55 The assessment provisions described in paragraph 3.51 or 3.52 do not relieve the parties executing the instrument of their liability to any penalty to which they would otherwise be liable as described in paragraph 3.50.

[Remarks: For avoidance of doubt, this makes clear that even if the CSR has issued a notice of assessment, the parties to the instrument are still liable to the penalty referred to in paragraph 3.50.]

3.56 If an amount of stamp duty is paid in respect of an instrument purporting to be the stamp duty that would have been chargeable on the instrument, as referred to in paragraph 3.49 but the amount is less than the amount of the stamp duty that would have been chargeable on the instrument, as assessed by the CSR, and the difference is not paid by the expiration of 1 month from the date on which the assessment is made, we propose that, without prejudice to the liability of any person for the payment of the difference, any person liable as described in paragraph 3.49 is liable to pay to the CSR an additional stamp duty of an amount equal to interest on the amount of the outstanding duty at the rate of 4 cents per $100 (or part of $100) per day in respect of the period beginning on the expiration of a period of 1 month from that date and ending on the date of the full payment of the outstanding duty and additional stamp duty.

[Remarks: This is modeled on the existing section 13(10) of SDO. The proposed provision empowers the CSR to charge additional stamp duty in case the stamp duty payable under paragraph 3.49 is

not paid in full within the 30-day time limit and the CSR issues an assessment under paragraph 3.51 or 3.52 but the further duty assessed is not paid within one month from the date on which the assessment is made.]

3.57 The CSR may remit the whole or any part of any additional stamp duty payable as described in the preceding paragraph.
[Remarks: This is modeled on section 13(11) of SDO.]

F. Key miscellaneous amendments

3.58 We propose to apply the 6-year limitation period for recovery of stamp duty in the existing section 4 (charging of, liability for, and recovery of stamp duty) of SDO to the stamp duty charge proposed in paragraph 3.49 above, but the limitation period will begin to run after the occurrence of an IA disqualifying event within the meaning of paragraph 3.45.1, or, as the case requires, the earliest IA disqualifying event. This proposed treatment is in line with that proposed under IRO.

3.59 For the sake of consistency, we propose to update the existing section 45 (relief in case of conveyance from one associated body corporate to another) of SDO and introduce a mechanism for the CSR to make and issue an assessment under that section by reference to the proposal set out in paragraphs 3.49 to 3.57 above.

3.60 In this connection, we propose to apply the current appeal procedures, requirements and relaxations in section 14 (appeal against assessment) of SDO to the assessment of the CSR made under the updated section 45 or in respect of an investment arrangement in an alternative bond scheme as proposed in paragraph 3.51 or 3.52 above.

3.61 We also propose to expand the scope of section 58A (representations may be made to CSR before certain penalties are imposed) of SDO and section 58B (remission of certain penalties) of SDO to cover the penalties proposed in paragraphs 3.43.5 and 3.47.6 above. By so doing, the rights of making representation under section 58A and the remission under section 58B can be extended to the originator and bond-issuer under an investment arrangement in an alternative bond scheme.

Question 12

Do you have any other views or comments on the proposed amendments to SDO?

LIST OF QUESTIONS FOR CONSULTATION

Chapter 3	Question 1	Do you agree that the description in paragraph 3.2 can accurately reflect the general features of sukuk in the market? Please explain the reasons for your views.
	Question 2	Do you agree that the description in paragraph 3.4 can accurately reflect the key features of the underlying structure of Ijarah sukuk in the market? Please explain the reasons for your views.
	Question 3	Do you agree that the description in paragraph 3.5 can accurately describe the asset replacement scenarios? Please explain the reasons for your views.
	Question 4	Do you agree that the description in paragraph 3.6 can accurately reflect the key features of the underlying structure of business-plan Musharakah and Mudarabah sukuk in the market? Please explain the reasons for your views.
	Question 5	Do you agree that co-ownership Musharakah sukuk structure can be accommodated under the leaseback arrangement? If not, please explain the reasons for your views and the detailed structure of this kind of sukuk in the market.
	Question 6	(a) Do you agree that the description in paragraph 3.10 can accurately reflect the key features of the underlying structure of Murabahah sukuk in the market? Please explain the reasons for your

views.

(b) The description in paragraphs 3.10.1 to 3.10.3(a) above is mainly intended to cater for a fixed-rate commodity Murabahah sukuk structure. Is it very common to see a floating-rate commodity Murabahah sukuk structure in the market? If so, please explain the detailed operations of this kind of structure.

(c) Is it very common to see replacement of asset due to destruction or loss under a Murabahah sukuk structure? If so, please explain the detailed arrangement under this scenario.

Question 7 Do you agree with the qualifying conditions proposed for the bond arrangement and investment arrangement under IRO? Please explain the reasons for your views.

Question 8 Do you agree that the special tax treatment in paragraphs 3.16 and 3.17 is sufficient to provide a level playing field for sukuk vis-à-vis their conventional counterparts in terms of tax liabilities? Please explain the reasons for your views.

Question 9 Do you have any other views or comments on the proposed amendments to IRO?

Question 10 Do you agree with the qualifying conditions and requirements proposed for the bond arrangement and investment arrangement under SDO? Please explain the reasons for your views.

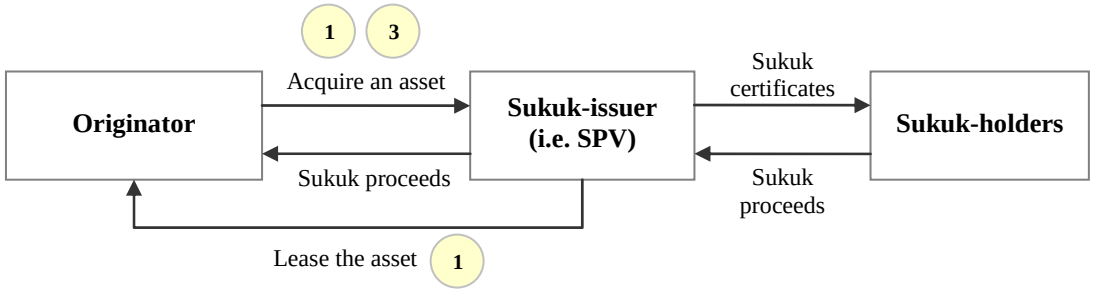
Question 11 Do you agree that the stamp duty treatment /

	relief in paragraphs 3.39 and 3.40 is sufficient to provide a level playing field for sukuk vis-à-vis their conventional counterparts in terms of stamp duty liabilities? Please explain the reasons for your views.
Question 12	Do you have any other views or comments on the proposed amendments to SDO?

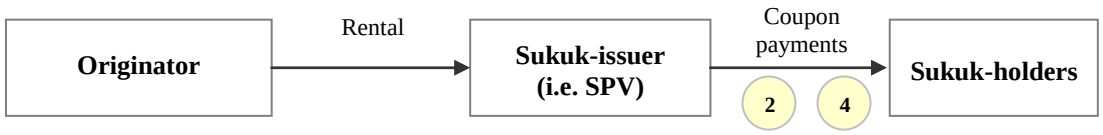
Annex 1

Key Tax Issues in relation to Sukuk Issuance under Our Existing Tax Regime (using Ijarah sukuk structure as an example)

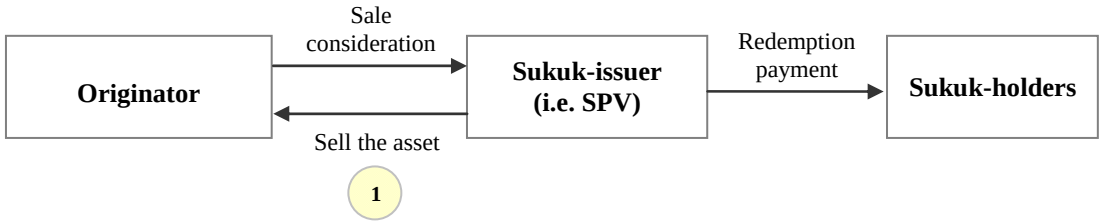
Formation



Periodic payments



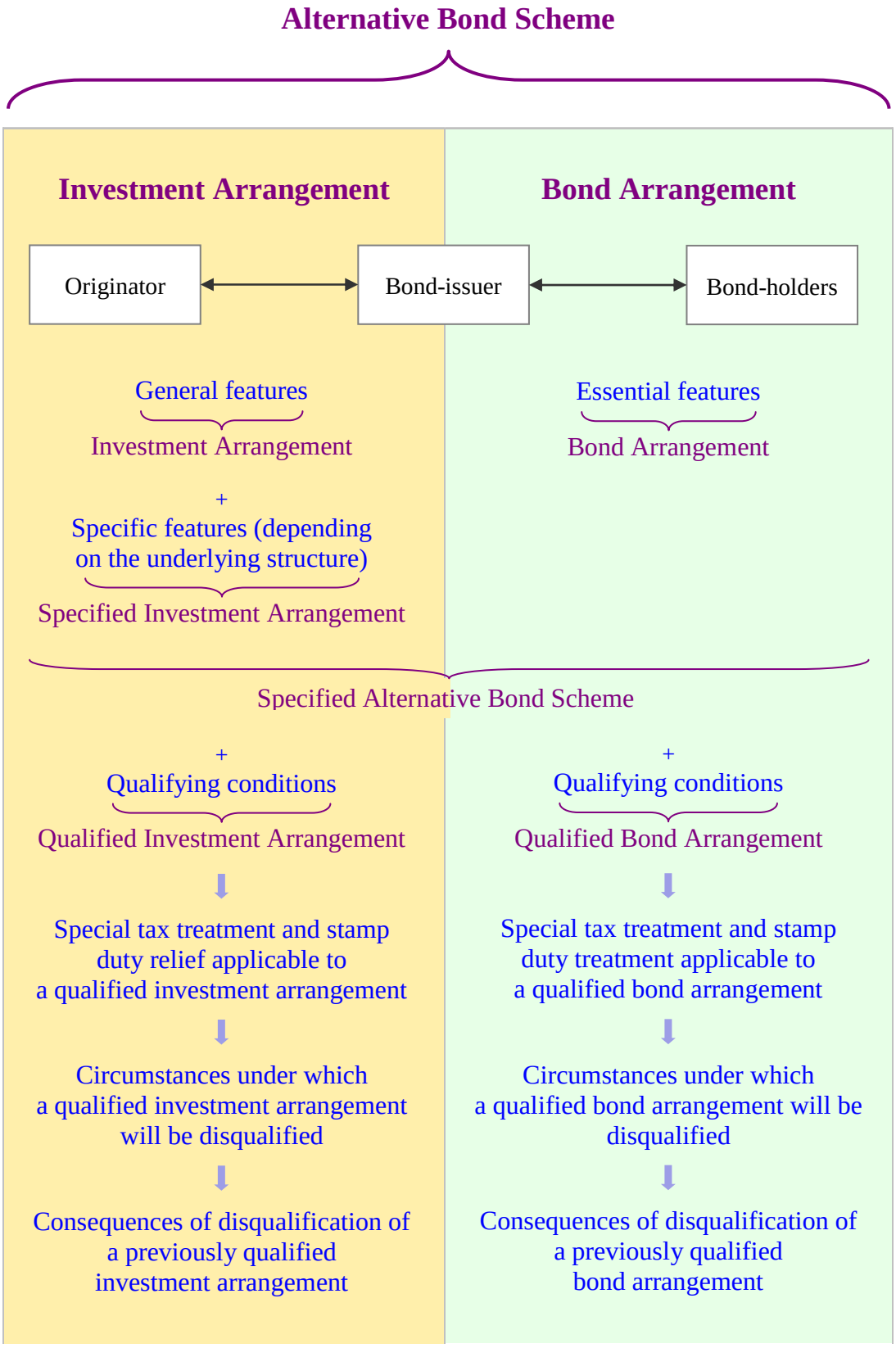
Maturity



1. If the underlying asset involved is Hong Kong immovable property, 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;
2. The coupon payments made by the SPV to sukuk-holders are not tax deductible as they are profit distributions in legal form;
3. The originator of the sukuk may no longer be entitled to depreciation allowances associated with the underlying asset as the asset has been transferred to the SPV during the sukuk term; and
4. The existing QDI scheme does not cover sukuk, so the coupon payments and disposal gains derived from sukuk cannot enjoy relevant tax concession / exemption under the scheme.

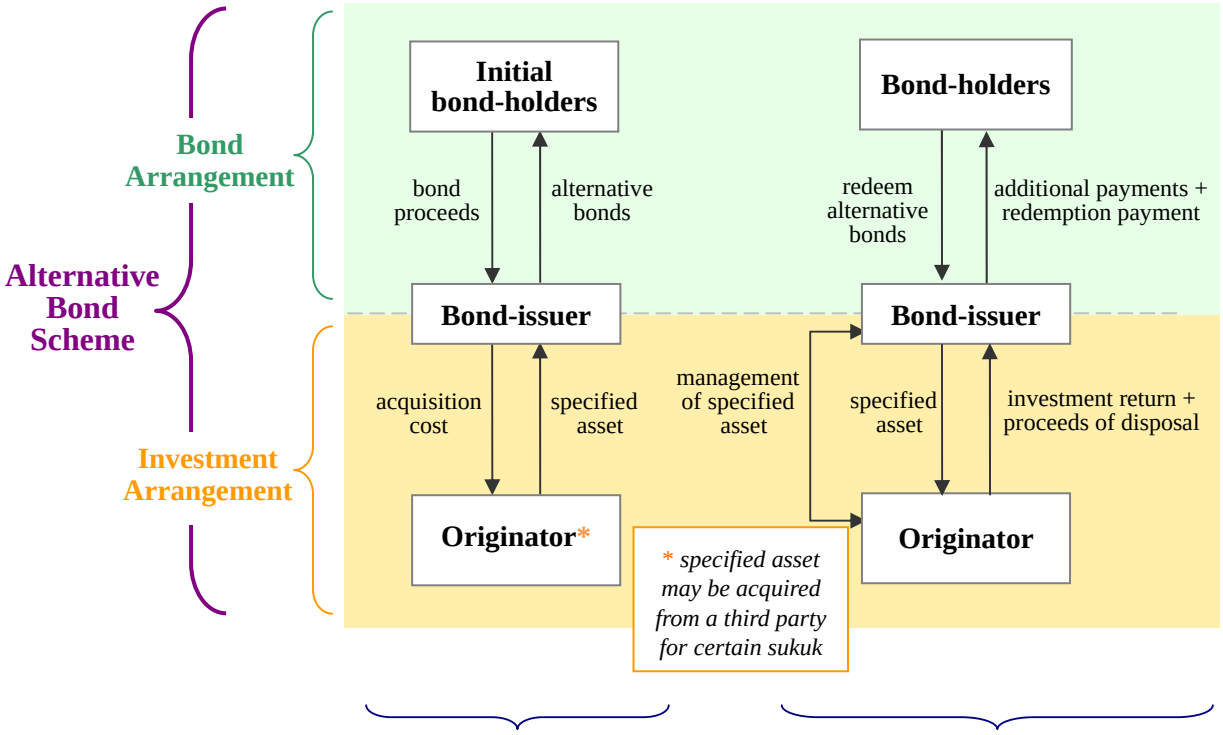
Annex 2

Diagram on the Framework of the Proposed Legislative Amendments



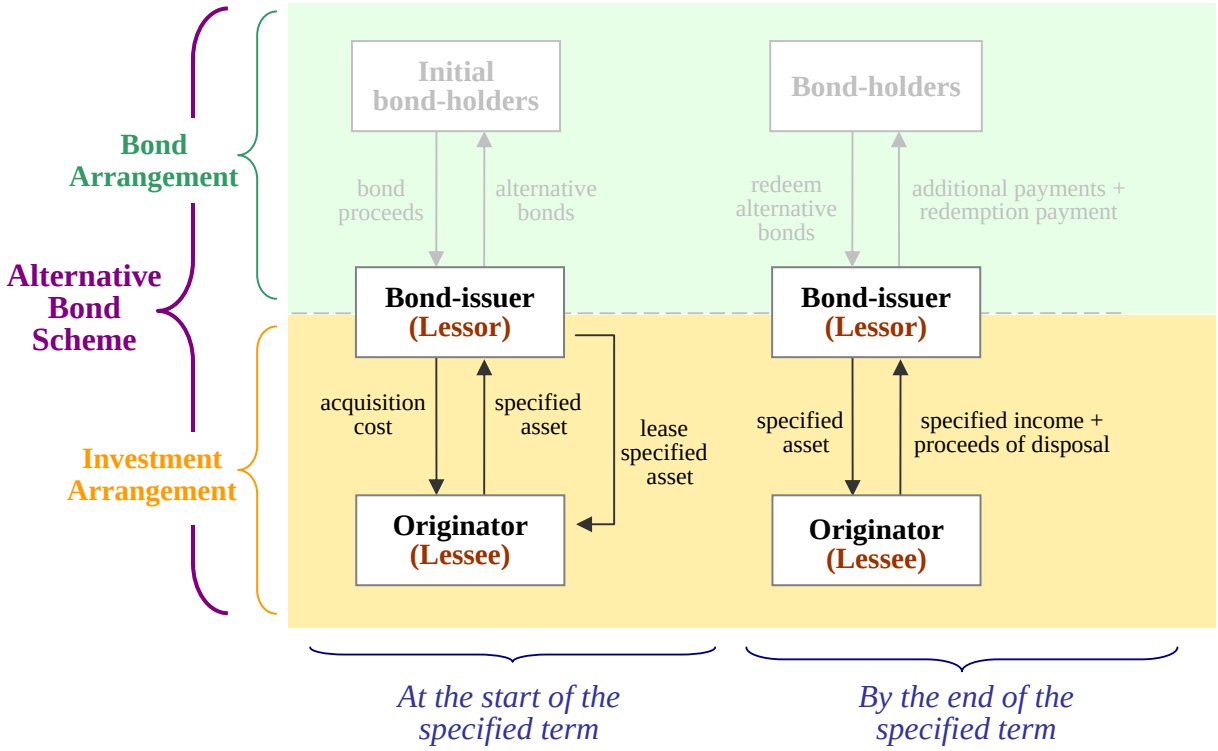
Annex 3

Diagram Illustrating the Essential Features of Alternative Bond Scheme, Bond Arrangement and Investment Arrangement



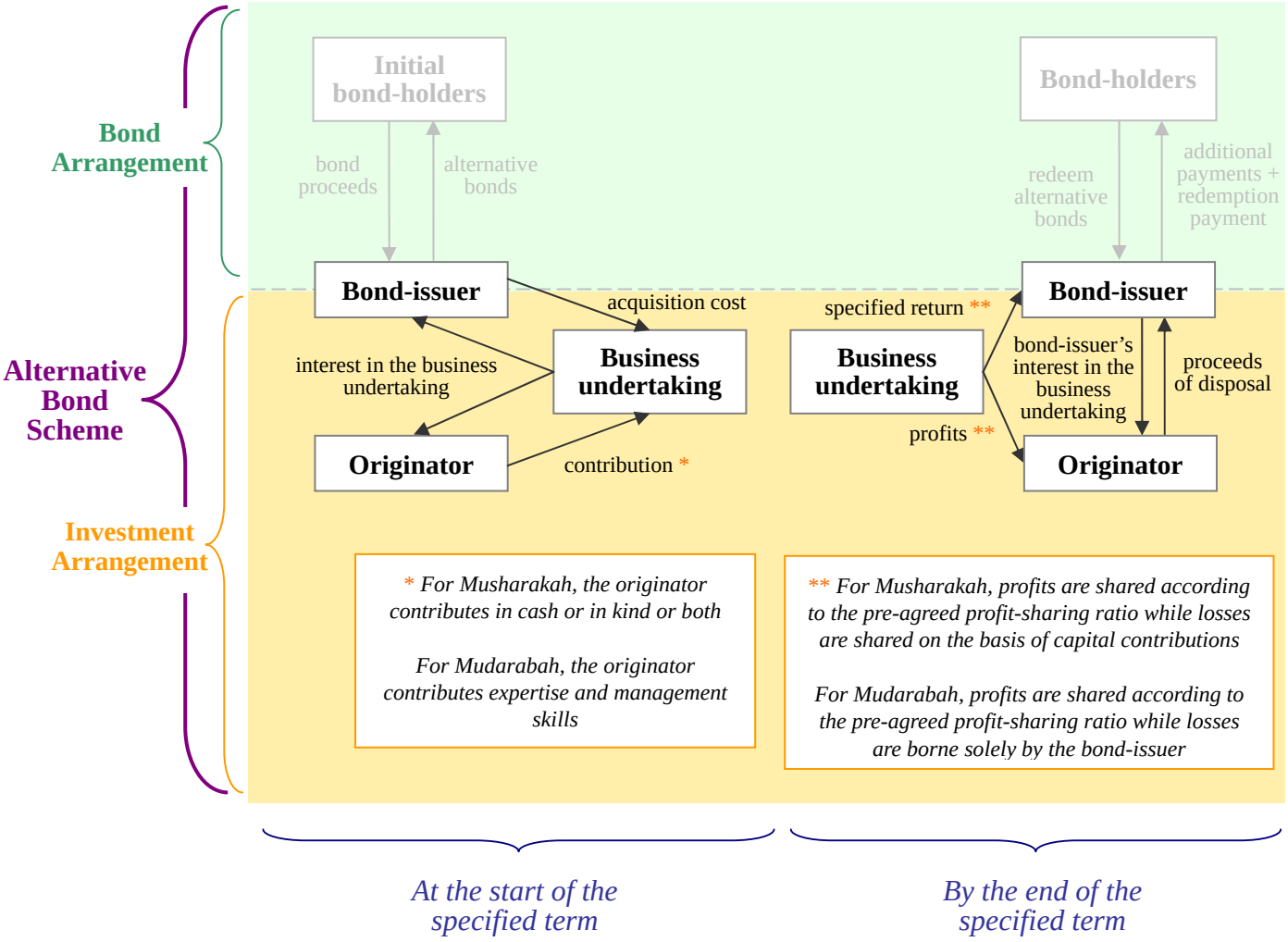
Annex 4

Diagram Illustrating the Specific Features of Leaseback Arrangement (Ijarah Sukuk Structure)



Annex 5

Diagram Illustrating the Specific Features of Profits Sharing Arrangement (Musharakah and Mudarabah Sukuk Structures)



Annex 6

Diagram Illustrating the Specific Features of Purchase and Sale Arrangement (Murabahah Sukuk Structure)