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Development of Islamic finance in Hong Kong

The promotion of Islamic finance was articulated as a key policy initiative by the Hong Kong Chief Executive in 2007 and, after rounds of consultation and refinement, a 200+ page bill that amends both the Inland Revenue Ordinance and the Stamp Duty Ordinance was passed on 19 July 2013 and entered into force as from that date. The measures in the legislation are designed to provide a level playing field for Islamic finance from a Hong Kong tax perspective. Given Hong Kong's emphasis on maintaining its simple tax system, the scale of the changes is remarkable.

This article looks at the changes enacted by the bill and explores Hong Kong’s potential to become an Islamic financial hub from a tax perspective. The value of Islamic finance assets worldwide, estimated at USD 1.34 trillion in 2012, is growing at a compound annual rate of 15% to 20%. During the global financial crisis, Islamic finance assets demonstrated their superior stability compared to traditional financial products due to their linkage with tangible assets (as compared to derivatives created under the conventional finance system). Recognizing the potential of the system, a number of countries already have taken steps to facilitate and promote Islamic finance and have become Islamic financial hubs. One approach, which has been adopted by countries such as Japan, Malaysia, Singapore and the United Kingdom, is to amend the domestic tax rules to make them conducive to an Islamic finance market.

As a reputable international financial center, Hong Kong is well positioned to become a regional Islamic financial hub. Beneficial features of the Hong Kong system include the following:

- No. 1 ranking in the World Economic Forum's Financial Development Index for 2011 and 2012;
- Role as gateway for investing into China and favorable double taxation arrangement with China;
- High liquidity;
- Free economy;
- Strong presence of foreign banks;
- Simple tax system with no withholding tax, except on royalties; and
- Cooperation agreements with Dubai for developing Islamic banking to take advantage of the liquidity in the Gulf Cooperation Council region.

Before considering the legislative changes in Hong Kong, this article will first examine what Islamic finance actually is.

What is Islamic finance?

Very broadly speaking, the two fundamental characteristics in which Islamic finance differs from traditional finance are as follows:

1. Muslims may not invest in the following businesses:

- Alcohol;
- Pork-related products;
- Conventional financial services;
- Entertainment;
- Tobacco; and
- Weapons and defense.

2. The charging or paying of "interest" is prohibited.

Although Shariah law prohibits the charging or paying of interest, it does not preclude other forms of return on an investment, such as rent or profits, that the parties agree on at the time they enter into the contract.

Shariah-compliant products

Most discussion of Islamic finance concerns the various investment and bond arrangements arising from Feature 2, i.e. the prohibition on interest (see below). However, Feature 1—the prohibition on certain types of investment—is no less important, as it determines the types of investments Muslims can undertake. Jurisdictions without a large Muslim population can design products that will attract investment from Muslim jurisdictions. Accordingly, various jurisdictions have facilitated the establishment of funds encompassing investments that meet the Feature 1 criteria, and Hong Kong is no exception. The Dow Jones Islamic Market China and Hong Kong Titans Index was set up in 2007, following the Chief Executive's policy speech in the same year, to track the performance of the 30 largest Hong Kong Shariah-compliant listed companies with primary operations in Hong Kong and Mainland China. The Hang Seng Islamic China Index Fund is one of the funds that invest in such index constituent stocks (i.e. Hong Kong-listed shares, including "H shares" (shares of companies established in Mainland China that are traded on the Hong Kong stock exchange)). In short, Hong Kong has had mechanisms to attract investment from the Muslim population since 2007.

Due to the rapid and continuing economic growth of China, more funds are investing directly into Shariah-compliant Chinese companies listed on the Shanghai or Shenzhen stock exchanges through the Qualified Foreign Institutional Investor (QFII) program, even though an Islamic tracking index has not yet been set up for "A shares" (i.e. shares of companies established in Mainland China denominated in yuan that are traded on the Shanghai and Shenzhen stock exchanges; A shares generally can only be bought and sold by non-Chinese individuals or companies through the QFII program).

The QFII program, launched in 2002 in China, permits licensed foreign investors to buy and sell yuan-denominated A shares on the Shanghai and Shenzhen stock exchanges. From both Chinese and Hong Kong tax perspectives, it is advantageous to use a Hong Kong company as the vehicle for investing in A shares under the QFII program. One of the key benefits is the potential savings in Chinese Enterprise Income Tax under the China-Hong Kong double taxation arrangement when the Hong Kong company disposes of the shares of the Chinese company, provided (i) the Hong Kong company does not own 25% or more of the Chinese company at any time within the 12-month period before the date of disposal; and (ii) the Chinese company is not a land-rich company (i.e. more than 50% of the value of the Chinese company's assets must not comprise real estate located in China directly or indirectly).

Under the QFII program, no single foreign investor is permitted to hold more than 10% of a Chinese company, so under the double taxation arrangement, such disposal gains may be taxed only in Hong Kong and may not be taxed in China. In Hong Kong, gains derived from the disposal of A shares traded only on a Chinese stock exchange are offshore-sourced and therefore nontaxable, which effectively means that such gains are potentially free of both Chinese and Hong Kong income taxes. There is, however, an uncertainty around this structure as to whether the Chinese Tax Authorities would, due to the consideration of anti-treaty abuse, deny the relief to the Hong Kong investment vehicle, which in many cases may just be holding the investments on behalf of other investors.

Investment arrangements

Feature 2 deals with day-to-day loan arrangements between Muslims and Islamic financial institutions. Since "interest" is prohibited under Shariah law, alternative arrangements ("investment arrangements") have to be deployed. These investment arrangements are more common in jurisdictions where there is a high population of Muslims. Hong Kong's recent legislation deals with the following types of arrangements (other arrangements, such as Takaful (insurance arrangements), which are commonly accepted in other countries, are not covered by the legislation):

- Ijarah (leaseback arrangements);
- Musharakah and Mudarabah (profit sharing arrangements);
- Murabahah (purchase and sale arrangements); and
- Wahalah (agency arrangements).

Under these arrangements, “interest” is replaced by another form of reward, such as rent or profits. Below are some examples demonstrating how these investment arrangements may work in practice.

In an Ijarah arrangement (Diagram 1), the borrower may wish to borrow using its own property as collateral. To achieve this in a Shariah-compliant manner, the lender would purchase the property and then lease it back to the borrower. After a number of years, the borrower would repurchase the property from the lender. The “rental payments” would, in substance, represent the interest element.

Under Musharakah and Mudarabah arrangements (Diagram 2), the borrower wishes to borrow funds to embark on a new business. To comply with Shariah law, the lender would enter into a business undertaking with the borrower under which the lender would contribute money and the borrower would make a cash or in-kind contribution (Musharakah), or would contribute management or expertise and management skills (Mudarabah). The lender and the borrower would share the profits or losses arising from the undertaking. At the end of the arrangement, the borrower will purchase the lender's interest in the business undertaking. The return to the lender during the arrangement may be regarded as representing interest in certain cases.

In a Murabahah arrangement (Diagram 3), the borrower may wish to borrow to purchase trading stock. To comply with Shariah law, the lender would first acquire the stock for an on-sale to the borrower at a mark-up. The borrower then would settle the purchase price on a deferred basis (e.g. after it sells the stock). The mark-up may be regarded as representing the interest charge.

In a Wahalah arrangement (Diagram 4), the borrower seeks to borrow to purchase an asset to generate recurring income. To comply with Shariah law, the lender would buy the asset and appoint the borrower as its agent in managing the asset. After a specified period, the lender would sell the asset to the borrower. During the interim period, the lender would receive income or gain from the management of the asset by the borrower acting as the lender's agent. The lender in turn would pay an agency/incentive fee to the borrower. The net return to the lender of the difference between the income or gain and the agency/incentive fee expenses may be regarded as representing the interest element.

Bond arrangements (sukuk)

The discussion that follows looks at how Islamic financial institutions source their own financing in a Shariah-compliant manner.

In addition to using their own equity, financial institutions can raise financing through the issuance of bonds. The ability of bondholders to redeem the bonds upon their expiration date means that there is no "interest" charge as such, although, in economic terms, the difference between the redemption price and the issuance price would closely resemble the "interest" element. Such a bond arrangement can involve unlisted or listed bonds on a local or foreign stock exchange.

While different jurisdictions accord different tax treatment to bond arrangements and the investment arrangements discussed above, most take a "tax neutral" approach, such that both the investment and the bond arrangements receive the same tax treatment as in the case of conventional finance. For example, under an Ijarah arrangement (leaseback), the sale and repurchase transactions generally would be disregarded, with the rental income effectively being deemed an interest expense and the purchase (or repurchase) amount deemed a loan. An exemption would be granted from any transaction taxes, such as stamp duty, that otherwise would be charged on a sale and repurchase transaction. The same would apply to other investment arrangements, i.e. the transaction would be taxed as if it were a loan transaction involving an interest payment. In addition to providing this tax neutral treatment, some countries offer additional incentives to promote Islamic finance. For example, Malaysia grants a full tax exemption to Islamic banks on income derived from Islamic banking business conducted in international currencies from year of assessment 2007 to 2016. Singapore reduces the income tax rate on Islamic finance activities to 12% (compared to the normal 17%), now that the 5% concessionary tax rate that applied from 1 April 2008 to 31 March 2013 has expired.

The legislation in Hong Kong does not confer any additional tax incentives, but does grant tax neutral treatment. Some of the conditions that must be satisfied to obtain tax neutral treatment are unique:

1. *Requirement that bond arrangements relate to investment arrangements:* Under this legislation, if an investment arrangement exists, there must be a related bond arrangement before tax relief may be granted. In other words, if a financial institution simply enters into an Ijarah with a borrower without issuing any bonds to finance the transaction, no tax relief would be available under the transaction. This differs from the approaches taken by other countries, such as the United Kingdom, Malaysia, Singapore, etc. This approach implies that the Hong Kong government’s intention is probably not to implement Islamic finance on a "retail" scale, but rather on a "wholesale" scale (see also point 2). This also may prevent some taxpayers from using Ijarah arrangements to avoid the payment of stamp duty and profits tax in avoidance schemes involving property transactions.

2. *Requirement that investment and debt arrangements be classified as "loans" from an accounting perspective:* This condition in Hong Kong’s legislation would require that both investment and debt arrangements be treated as a financial liability in accordance with Hong Kong Financial Reporting Standards or International Financial Reporting Standards. From an accounting perspective, both the investment and the debt arrangement would be classified as loan and interest transactions. This could pose problems for some Shariah-compliant investment arrangements, such as Musharakah and Mudarabah, in which profits and losses are shared. In practice, many Musharakah and Mudarabah have been structured as products with a fixed percentage of distribution on profits

benchmarked at an interest rate. (For this reason, it is not surprising that some Islamic scholars have commented that current sukuk may not be Shariah-compliant, since under Shariah principles there should be no fixed rate of profit or guaranteed refund of capital.)

3. *Requirement that bonds have a "Hong Kong connection":* Bonds issued under the debt arrangement must be connected with Hong Kong in some way, i.e. they must be listed on the Hong Kong stock exchange or be issued in good faith and in the course of carrying on business in Hong Kong, marketed in Hong Kong or lodged with and cleared by the Central Moneymarkets Unit operated by the Monetary Authority.

There are other conditions relating to investment and debt arrangements, such as the "maximum term length," "bond-issuer as conduit," etc. that must be satisfied if tax neutral treatment is to apply. Nevertheless, the distinctive conditions above provide a basic landscape as to how Islamic finance in Hong Kong will operate going forward.

Conclusion

China currently has not stipulated policy to offer tax neutral treatment for Islamic finance, although the Ningxia Hui Autonomous Region, the region with the highest Muslim population in China, has been considered a hub for Islamic finance since 2008. Given Hong Kong's peripheral position, the new legislation should open the door for Islamic banking, though perhaps, at this stage, not as widely as that door has been opened in other countries.

Diagram 1 - Ijarah (Leaseback Arrangement)

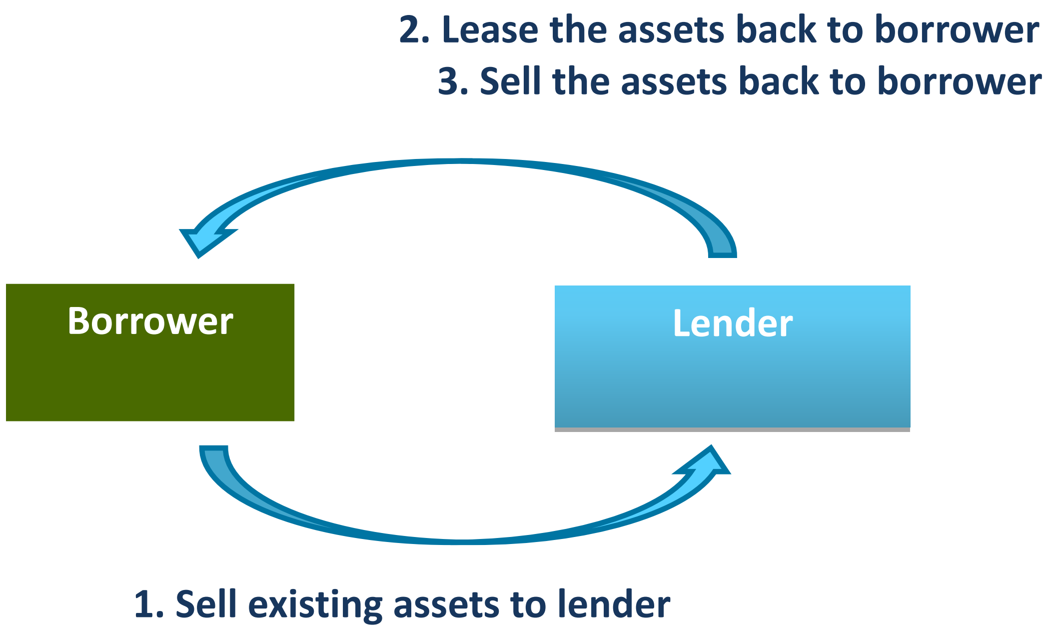
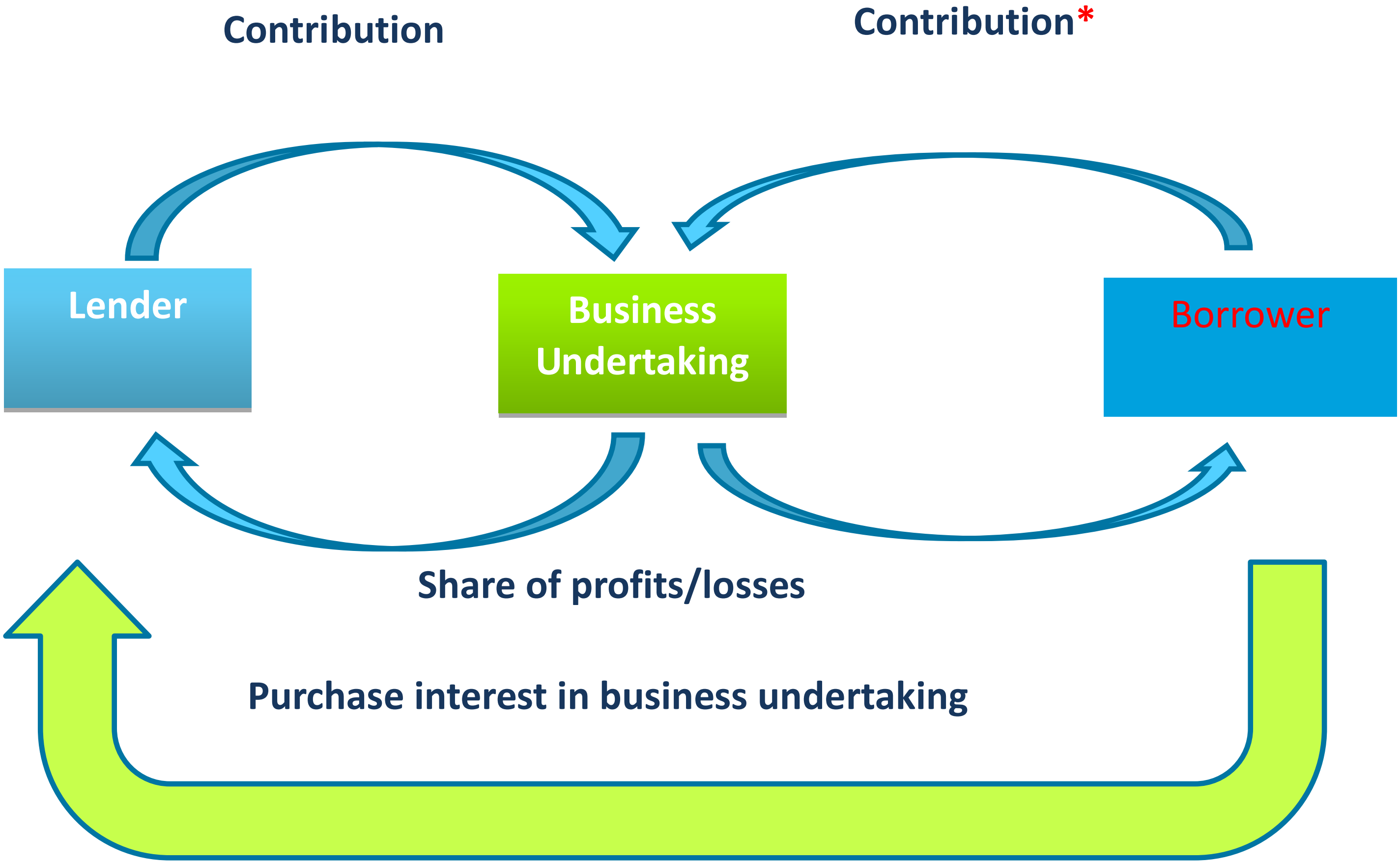


Diagram 2: Musharakah and Mudarabah (Profit Sharing Arrangements)



*Musharakah - Borrower contributes cash or in kind
Mudarabah - Borrower contributes expertise and management skills

Diagram 3: Murabahah (Purchase and Sale Arrangement)

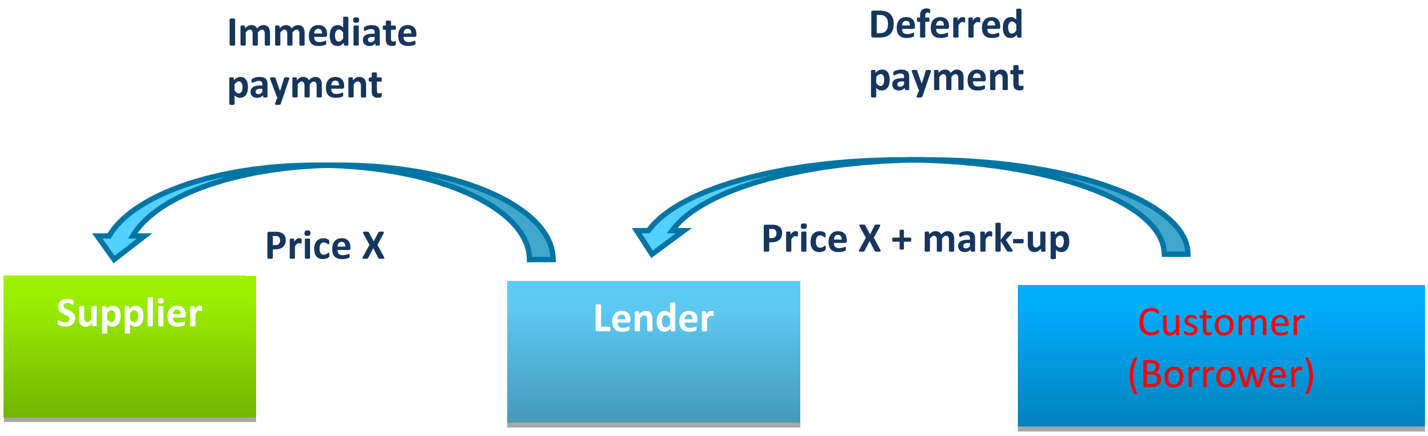
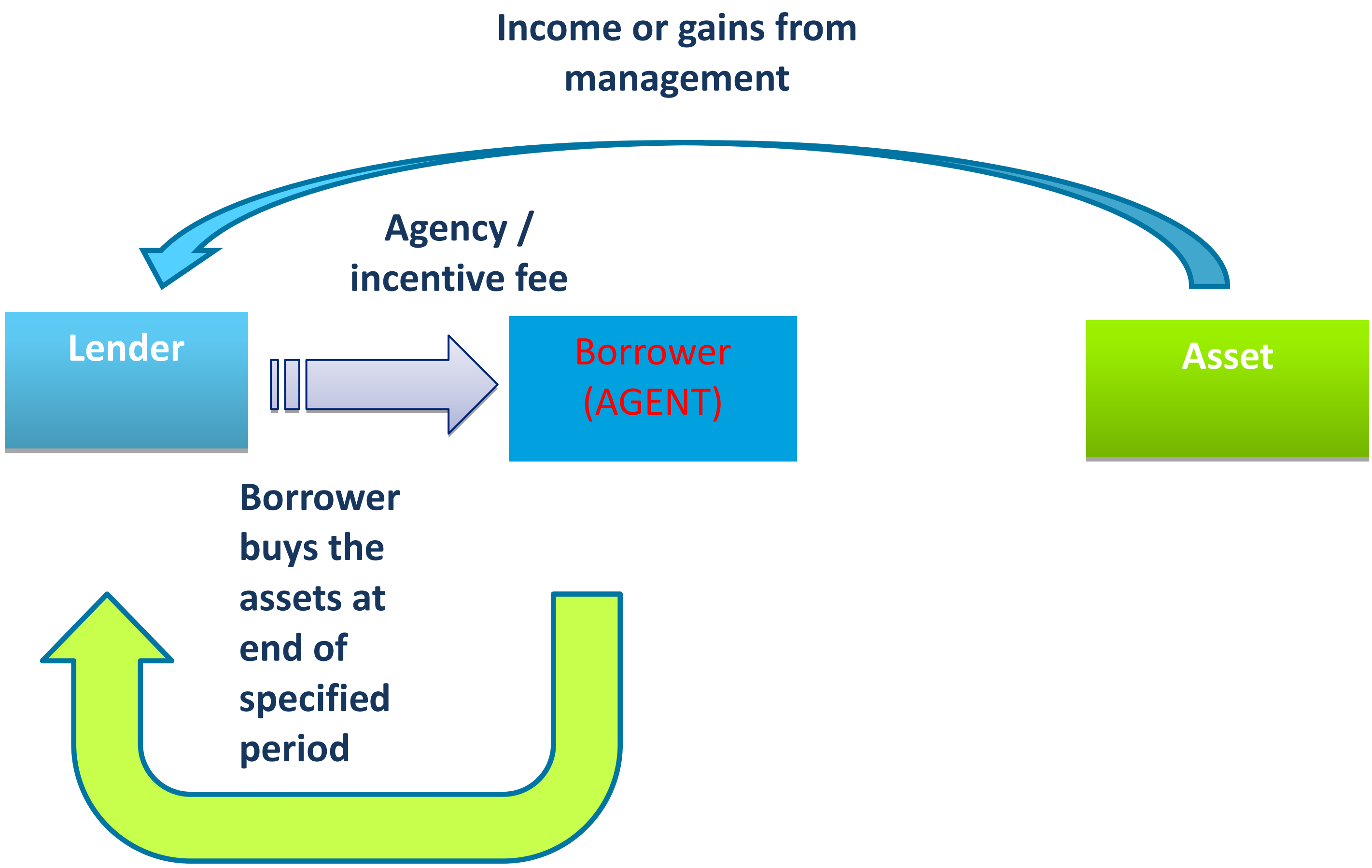


Diagram 4 - Wahalah (Agency Arrangement)



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