



Inland Revenue Department

The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 50

TAXATION OF SPECIFIED ALTERNATIVE BOND SCHEMES

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

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Commissioner of Inland Revenue

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INTRODUCTION

Distinguishing sukuk from conventional bonds

The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 (the Amendment Ordinance) was enacted by the Legislative Council in July 2013 to bring particular types of arrangements that are economically equivalent to debt arrangements under tax rules comparable to those applying to debt arrangements and to give stamp duty relief in relation to those types of arrangements. This Departmental Interpretation and Practice Note sets out the Department's views and practice on the application of the provisions in section 40AB and Schedule 17A (the Schedule) of the Inland Revenue Ordinance (the IRO) whereas Stamp Office Interpretation and Practice Notes No. 6 will cover the interpretation and practice of relevant provisions in the Stamp Duty Ordinance.

2. Issuance of conventional bonds is not consistent with Sharia principles which prohibit payments for use of money (i.e. interest). To accommodate that precept, alternative financial arrangements have been developed. The return from many of these arrangements is economically equivalent to interest. The Amendment Ordinance adopts a religion neutral approach, stipulating the conditions under which arrangements are treated as debt arrangements. In *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd and Others* [2004] 4 AllER 1072, the English Court of Appeal held that English law alone was the governing law even though the governing law clause was subject to Sharia principles.

3. Though commonly called Islamic bonds, sukuk (the plural of sakk) are in essence trust certificates backed by Sharia-acceptable assets. The form of the documentation and the issue process are similar to those of an issue of conventional bonds. However, the instrument, rather than being a debt obligation, confers rights on the holders as beneficiaries under a trust of the relevant asset backing the deal. The holders' return is thus profit derived from their beneficial ownership of the asset rather than interest on a debt. Many sukuk are economically equivalent to conventional bonds but some sukuk are non-debt arrangements (e.g. equity instruments).

ALTERNATIVE BOND SCHEME

Basic structure

4. The term “alternative bond scheme” (ABS) is used in the Amendment Ordinance to represent the arrangements which will be treated as debt arrangements for profits tax purposes upon fulfilment of certain conditions. Section 40AB in Part 6A refers to the Schedule which contains the provisions about the tax treatment of specified ABSs.

5. Generally, the ABS is a tripartite structure with the following participants:

- (a) the originator (the O) which may be in substance the borrower;
- (b) the bond-issuer (the BI) which must be a special purpose vehicle (the SPV); and
- (c) the bond-holders (the BHs).

The BI and the BHs enter into a bond arrangement (the BA) while the BI and the O enter into an investment arrangement (the IA). Under the BA, alternative bonds are issued to the BHs. Under the IA, assets are acquired and managed with a view to generating income or gains to fund the payments to the BHs in the BA.

Example 1

Company-BI issued alternative bonds to Companies-BH under a BA. Company-BI entered into an IA with Company-O under which the bond proceeds were used to acquire an asset to generate income and gains to fund payments to the Companies-BH.

The tripartite structure comprised a BA and an IA with Company-O, Company-BI and Companies-BH as the participants. The structure fell within the definition of ABS and the provisions in the Schedule would apply to the structure if other conditions are satisfied.

Example 2

To fund the acquisition of machinery for its own trade, Company-BI issued trust certificates under an arrangement to Companies-BH.

The bipartite structure did not fall within the definition of ABS. The provisions in the Schedule would not apply to the structure.

6. A specified ABS means an ABS with the IA being one of the four specified IAs and the terms of the ABS and IA remain the same throughout the specified term. The four specified IAs and the corresponding Islamic transactions/contracts are listed below:

<u>Investment Arrangement</u>	<u>Islamic Transaction/Contract</u>
Lease arrangement	Ijara
Profits sharing arrangement	Musharaka and Mudaraba
Purchase and sale arrangement	Murabaha
Agency arrangement	Wakala

Example 3

Company-BI issued alternative bonds to Companies-BH under a BA. The IA between Company-BI and Company-O was a lease arrangement. The terms of the ABS and IA remained unchanged throughout the specified term.

Since the IA was a specified IA and the terms of the ABS and IA remained unchanged throughout the specified term, the ABS was a specified ABS. If the lease arrangement had been changed to an agency arrangement before the alternative bonds were fully redeemed or cancelled, the ABS would not have been a specified ABS.

Example 4

Company-BI issued alternative bonds to Companies-BH under a BA. Company-BI and Company-O entered into an IA which consisted of a lease arrangement and a purchase and sale arrangement.

The scheme was not covered by the Schedule because it had two specified IAs. The Commissioner having considered all the facts and circumstances would decide whether such a hybrid structure, made up of two specified IAs, could be accepted as a specified ABS.

7. The BA in a specified ABS is a qualified BA if the specified ABS has always complied with:

- (a) the reasonable commercial return condition;
- (b) the BA as financial liability condition;
- (c) the Hong Kong connection condition;
- (d) the maximum term length condition; and
- (e) the arrangements performed according to terms condition.

If the BA in a specified ABS is a qualified BA, it would be regarded as a debt arrangement.

8. The specified IA in a specified ABS is a qualified IA if:

- (a) throughout the specified term, the BA in the specified ABS has always been a qualified BA; and
- (b) the specified ABS has always complied with:
 - (i) the BI as conduit condition, and
 - (ii) the IA as financial liability condition.

If the specified IA in a specified ABS is a qualified IA, it would be regarded as a debt arrangement.

9. The BA in a specified ABS is regarded as never having been a qualified BA in the specified ABS if a BA disqualifying event occurs in relation to the BA at any time during the specified term. Equally, the IA in a specified ABS is regarded as never having been a qualified IA in the specified ABS if an IA disqualifying event occurs in relation to the specified IA at any time during the specified term. The effect is that the debt treatment accorded to the BA and the IA will be withdrawn retrospectively, and assessments, additional assessments or reassessments will be raised accordingly.

Special purpose vehicle

10. The BI in an ABS must be an SPV which is a corporation, partnership or any other entity established solely for the purposes of the ABS and does not carry on any trade or activities except for the purposes of the ABS.

11. The definition excludes an SPV which is engaged in business activities apart from the alternative bond issuance. However, an SPV set up for more than one ABS with the same O is regarded as the SPV for each of those schemes. The relaxation will accommodate cases where an SPV is to issue a series of alternative bonds under an issuance programme.

Example 5

Company-BI had issued conventional bonds which were fully redeemed. Company-O made use of Company-BI to issue alternative bonds.

Company-BI did not meet the definition of an SPV since it was not established solely for the purposes of the ABS in question and was previously involved in issuance of conventional bonds.

Example 6

Company-BI was established as a property holding company but became dormant after disposal of its properties. Company-O made use of Company-BI to issue alternative bonds.

Company-BI did not meet the definition of SPV since it was not established solely for the purposes of the ABS in question and was involved in property investment.

Example 7

Company-O set up Company-BI solely for the purpose of an alternative bond issuance programme under which Company-BI issued a series of alternative bonds under four ABSs. The IAs in

two ABSs were lease arrangements while the IAs in the remaining two ABSs were profits sharing arrangements.

Company-BI was set up for an issuance programme and was the SPV in relation to each of the four ABSs. It was covered by the definition of SPV.

Example 8

Company-O set up Company-BI solely for the purpose of an alternative bond issuance programme under which four series of alternative bonds were issued. In two ABSs, the IAs were specified IAs while in the remaining two ABSs, the IAs were not specified IAs.

Company-BI met the definition of SPV since IAs were not required to be specified IAs. However, only two ABSs with specified IAs would be specified ABSs.

Specified term

12. Similar to debt arrangements, ABSs normally have a fixed term. Section 2(2) of the Schedule requires the ABS to have a specified term which commences on the date the alternative bonds are issued and ends on the date they are fully redeemed or cancelled under the terms of the BA. The “end date” usually refers to the scheduled redemption or cancellation date stated in the offering document or to a rescheduled redemption or cancellation date which is agreed by the Commissioner.

Example 9

On 1 October 2013, Company-BI issued to Companies-BH alternative bonds with a 3-year term redeemable on 30 September 2016. Pursuant to an IA, Company-BI purchased assets from Company-O with the bond proceeds and made arrangement for the management of the assets. Because of liquidity problems, the redemption date of the alternative bonds was extended to 30 September 2018.

The specified term of the ABS was initially three years (i.e. 1 October 2013 to 30 September 2016). It was subsequently changed to five years (i.e. 1 October 2013 to 30 September 2018). The extended specified term was conditional on the agreement of the Commissioner.

Essential features of a BA

13. The essential features of a BA are described in section 2(3) of the Schedule. In a BA, the initial BHs pay the bond proceeds to the BI and the BI:

- (a) enters into an IA with the O;
- (b) issues alternative bonds to the BHs; and
- (c) undertakes to use the investment return and proceeds of disposal under the IA for payment of the redemption payment and additional payments.

14. If the alternative bonds are transferable, the transferee of an alternative bond becomes the holder of the alternative bond after the transfer. Section 2(3)(e) of the Schedule provides that a BH can be either an initial or a subsequent BH. Thus the initial investors and subsequent buyers in the secondary market of alternative bonds are regarded as the BHs and are in a position comparable to initial investors and subsequent buyers of conventional bonds.

15. The redemption payment is economically equivalent to the principal repayment in conventional bonds. Additional payments are periodic distributions to the BHs out of the income or gains derived from the IA and are functionally similar to interest payments in conventional bonds. The additional payments may be fixed or determined by reference to a benchmark rate. In other words, alternative bonds can be structured either as fixed rate instruments or floating rate instruments. The BHs however are not to profit from any increase in the value of asset acquired with the bond proceeds.

16. Similar to conventional bonds, alternative bonds may be issued at a discount or redeemed at a premium. The par value above the discount price and the redemption premium would form part of the redemption payment and

not additional payments. There is no requirement in the Schedule that the BHs should receive back the issued price paid for the alternative bonds at the end of the specified term of the ABS. In other words, alternative bonds are subject to credit risks no different from those of conventional bonds.

17. Though not expressly provided in the Schedule, the alternative bonds may be exchangeable like some of the conventional bonds. That means the redemption may be satisfied by shares in the O or other companies. Since the BI is an SPV, the alternative bonds are not expected to be converted into shares in the BI.

18. The alternative bonds represent the rights and interests of the BHs in or in relation to the specified asset which was acquired by the BI under an IA with the bond proceeds. This is the most significant feature distinguishing alternative bonds from conventional bonds which only represent the debt owed by the BI to the BHs.

Specified asset

19. The specified asset is the asset acquired by the BI under an IA with the bond proceeds from a BA. The specified asset includes a replacement asset acquired upon the disposal, destruction or loss of the original specified asset.

20. Section 1(2) of the Schedule defines the term “asset” as any property or any class of property. “Property” as defined in section 3 of the Interpretation and General Clauses Ordinance (Cap. 1) includes:

- (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).

21. Since the term “asset” is given a very wide meaning, it should include tangible and intangible assets, whether a specific asset or a class of assets. The specified asset may be held until the end of the specified term or may be replaced during the specified term.

Example 10

Bank-O and Company-BI entered into an IA which was an agency arrangement. Bank-O as Company-BI's agent used the bond proceeds to acquire a portfolio of equities, equity linked notes and depositary receipts. During the specified term of the ABS, after disposal of the equities and equity linked notes, Bank-O as Company-BI's agent used the proceeds of disposal to acquire some debt securities.

The equities, equity linked notes, depositary receipts and debt securities would constitute specified assets of the ABS.

Essential features of an IA

22. The essential features of an IA are described in section 2(4) of the Schedule. The IA is an arrangement between the BI and the O, under which the BI:

- (a) uses the bond proceeds to acquire the specified asset;
- (b) arranges for the management of the specified asset to generate investment return during the specified term; and
- (c) is to dispose of the specified asset by the end of the specified term for a consideration (i.e. proceeds of disposal).

The specific features of each of the specified IAs in section 5 of the Schedule are further prescribed in sections 6 to 9 of the Schedule.

23. Legal fees, procurement fees, stamp duties and other expenses incidental to the issue of alternative bonds paid out of the bond proceeds will be treated by the Commissioner as part of the acquisition cost of the specified asset.

24. Depending on the type of IA and the terms of the IA, the specified asset may be acquired from the O or a third party. In the acquisition of the specified asset, the BI may obtain legal or beneficial interests in properties or rights to income.

25. The term “management” has a wide meaning. Section 3(2) of the Schedule defines the term “management” to include the disposal and replacement of the specified asset. The BI is not required to undertake the management. An agent, such as the O, can be appointed to perform the management activities. In a lease arrangement, the management activities are often documented in a service agreement or a management agreement. In a profits sharing arrangement or an agency arrangement, the management activities are often documented in the partnership agreement or the agency agreement. In a purchase and sale arrangement, management activities are often minimal given that the specified asset is immediately resold by the BI to the O after acquisition.

26. The BI is required to dispose of the specified asset by the end of the specified term. The disposal may take place earlier than originally scheduled due to the early redemption or cancellation of alternative bonds. The disposal may also be postponed if the O, due to insolvency, delays or fails to honour the pre-agreed purchase of the specified asset from the BI. In fact, section 28 of the Schedule may accommodate such a delay.

27. The BI is required to use the investment return and proceeds of disposal under the IA or part of these sums for payment of the redemption payment and additional payments. The BI or the O may arrange a top-up facility to meet payments in case the investment return and proceeds of disposal are insufficient to fund the redemption payment or additional payments payable to the BHs under the BA.

SPECIFIED INVESTMENT ARRANGEMENTS

28. Section 5 of the Schedule specifies four types of IAs, namely:

- (a) a lease arrangement;
- (b) a profits sharing arrangement;
- (c) a purchase and sale arrangement; or
- (d) an agency arrangement.

Sections 6, 7, 8 and 9 of the Schedule further provide for the details of the structures of the specified IAs.

Lease arrangement

29. The provisions in section 6 of the Schedule which relate to lease arrangements are intended to cover ijara structures. If an arrangement satisfies the conditions therein, it will be regarded as a lease arrangement.

Specific features

30. In a lease arrangement, the BI:

- (a) uses the bond proceeds (the acquisition cost) to acquire the specified asset;
- (b) is to hold the specified asset until the end of the specified term;
- (c) leases the specified asset to the O for a specified income; and
- (d) is to dispose of the specified asset to the O, whether or not in stages, by the end of the specified term in return for the proceeds of disposal.

31. The BI may acquire the asset from the O or a third party. The third party may or may not be an associate of the BI or the O.

32. The specified asset may be a lease granted to the BI by the O in respect of immovable properties or other assets held by the O. For example, after acquiring a lease of a commercial building from the O, the BI may sublease it back to the O for a number of years. In this connection, to acquire the asset means to obtain the lease; to lease the asset means to sub-lease; and to dispose of the asset means to surrender the lease.

33. Section 6(2) of the Schedule allows for replacement of the specified asset in whole or in part subject to the following conditions:

- (a) if the replaced asset is not destroyed or lost, the replacing asset is acquired from a person in consideration of the disposal of the replaced asset to that person;
- (b) if the replaced asset is destroyed or lost, the replacing asset is acquired from a person with the consideration received for the disposal to that person of any remains of the replaced asset

- and any insurance money and other compensation arising from the destruction or loss;
- (c) the person in (a) or (b) above is either the O or the third party from whom the specified asset was initially acquired with the bond proceeds;
 - (d) the replacing asset for a replacement in whole or the replacing asset and the remainder asset for a replacement in part must be subject to the specified ABS until any further replacement.

34. The lease arrangement may involve co-ownership of an asset. If the O and the BI contribute cash to acquire an asset or the O sells part of the proprietary interest in an asset to the BI, the O and the BI would become co-owners of the asset. The BI then leases its share of the asset to the O in return for rental income and the O undertakes to purchase the BI's share of the asset by the end of the specified term. The arrangement though involving co-ownership of the asset by the O and the BI would be a lease arrangement.

The originator

35. In a lease arrangement, the O is the lessee of the specified asset and the person to whom the BI will dispose of the specified asset by the end of the specified term as described in section 6(1)(c) and (1)(d) of the Schedule.

Specified income

36. The specified income under a lease arrangement is the consideration payable by the O to the BI for leasing the specified asset as described in section 6(1)(c) of the Schedule.

37. Where the terms of the lease arrangement require payment of an additional rent to reimburse the BI the expenses incurred by the BI for the repairs and maintenance of the specified asset, the additional rent will not be counted as specified income for the purposes of calculating the investment return if it is fully offset by the repairs and maintenance expenses incurred by the BI.

38. On the destruction or loss of the specified asset, if the insurance or other compensation and the consideration received for the disposal of any

remains are not wholly used for redemption of the alternative bonds or acquisition of a replacing asset, the unused amount will be treated as specified income under section 10(5)(b) of the Schedule.

Specified asset transaction between the originator and the bond issuer

39. The specified asset transaction refers to any acquisition, leasing or disposal of the specified asset, in whole or in part, by the BI from or to the O as explained in section 6(3) of the Schedule. If the lease arrangement is a qualified IA, the specified asset transaction will be disregarded for profits tax and property tax purposes according to section 22(3)(a) of the Schedule.

Investment return

40. Section 10 of the Schedule describes the formula for calculating the investment return paid or payable in a period as follows:

$$A + B - C + D$$

- A : the total amount of specified income paid or payable in the period
- B : the specified proceeds of disposal paid or payable in the period
- C : the specified acquisition cost paid or payable in the period
- D : the total amount of any other sums paid or payable by the O to the BI in the period

If the proceeds of disposal are applied towards the full or partial redemption of the alternative bonds, specified proceeds of disposal means the sum of:

- (a) the consideration for the disposal of the whole or part of the specified asset; and
- (b) the insurance and compensation money arising from the destruction or loss of the whole or part of the specified asset and any consideration received for the disposal of any remains.

If the proceeds of disposal are applied towards the full or partial redemption of the alternative bonds, specified acquisition cost means the sum of:

- (a) the acquisition cost attributable to the whole or part of the specified asset disposed of; and
- (b) the acquisition cost attributable to the whole or part of the specified asset destroyed or lost.

41. The following examples illustrate the working of the provisions relevant to lease arrangements and the calculation of investment return under lease arrangements.

Example 11

Under a specified ABS, Company-O and Company-BI entered into a lease arrangement and Company-BI issued alternative bonds of \$800 million with a specified term of 5 years and used the bond proceeds to acquire Building-1 from Company-O. Building-1 was leased back to Company-O for a period of 5 years. By a purchase and sale undertaking, Company-O agreed to buy back Building-1 at a price of \$800 million at the end of the specified term.

After 3 years, Company-O decided to sell Building-1 to a third party and executed a deed of exchange whereby Company-BI transferred Building-1 to Company-O and Company-O transferred Building-2 to Company-BI. Building-2 was subject to the same terms of the ABS applicable to Building-1 for the remainder of the specified term.

Company-BI acquired Building-2 from Company-O in consideration of the disposal of Building-1 to Company-O. The replacement met the conditions under section 6(2) of the Schedule.

If Company-BI had directly disposed of Building-1 to the third party purchaser in consideration of Company-O's transfer of Building-2 to it, the replacement would not have met the conditions in section 6(2) since the third party purchaser was not the same person from whom Building-2 was acquired.

If Building-1 and Building-2 (after the replacement) were leased to Company-O at a monthly rent of \$1 million, the specified income was the monthly rent of \$1 million. If Company-BI disposed of Building-2 to Company-O and used the proceeds of disposal of \$800 million to redeem the alternative bonds, both the specified proceeds of disposal and the specified acquisition cost would be \$800 million.

Example 12

On 1 October 2013, Company-BI issued \$600 million alternative bonds in the form of trust certificates with a 3-year term under an ABS. The trust certificates carried the right to receive distributions every 12 months of all income earned by Company-BI from the specified asset subject to a maximum rate of 5% p.a. The trust certificates would be redeemed at par on 30 September 2016.

Company-BI used the \$600 million to acquire a commercial building from Company-O and leased the building back to Company-O at \$2.5 million per month over the specified term of the ABS. Company-BI agreed to sell the building back to Company-O on 30 September 2016 for \$600 million which would be used to redeem the trust certificates. The trust would then be dissolved.

The investment returns paid or payable in the relevant periods would be expected as follows:

Relevant Period	A \$m	+ B \$m	- C \$m	+ D \$m	= IR \$m
1.10.2013 to 30.9.2014	30	0	0	0	= 30
1.10.2013 to 30.9.2015	60	0	0	0	= 60
1.10.2013 to 30.9.2016	90	600	600	0	= 90

Profits sharing arrangement

42. The provisions in section 7 of the Schedule which relate to profits sharing arrangements are intended to cover musharaka and mudaraba structures. If an arrangement satisfies the conditions therein, it will be regarded as a profits sharing arrangement.

Specific features

43. In a profits sharing arrangement, the BI and the O form a business undertaking (BU). The BI contributes the bond proceeds and the O contributes either:

- (a) a sum of money or in kind or both; or
- (b) expertise and management skills only.

The specified asset in the arrangement is the interest in the BU acquired by the BI with the bond proceeds.

44. The BI and the O will share the profits from the BU in accordance with the pre-agreed profits sharing ratio. If both the BI and the O contribute capital and the BU incurs losses, they will share the losses in proportion to their capital contributions. If the O does not contribute capital, the BI will bear the losses.

45. The profits shared by the BI may exceed the expected return payable to the BHs. The BI may pay a portion of its share of the profits to the O as an incentive fee if the profits are greater than expected.

46. The BI must hold its interest in the BU throughout the specified term unless there is a partial redemption of the alternative bonds. By the end of the specified term, the BI is to dispose of its interest to the O.

47. There is no restriction on the types of business activities carried on by the BU, which may include acquisition, leasing and disposal of an asset, from or to the O. The business activities may also include engaging in a property development project, acquiring and managing the business operations of a company, etc.

The originator

48. The O in a profits sharing arrangement is the person who forms the BU with the BI and to whom the BI will dispose of its interest in the BU as described in section 7(1)(a) and (1)(f) of the Schedule.

Specified return

49. The specified return under a profits sharing arrangement means the profits due to the BI, less the losses borne by the BI as described in section 7(1)(d) of the Schedule.

Specified asset transaction between the originator and the bond issuer

50. The specified asset transaction refers to the disposal by the BI of the specified asset, which is the interest in the BU, to the O. If the profits sharing arrangement is a qualified IA, the specified asset transaction will be disregarded for profits tax purpose according to section 22(3)(a) of the Schedule.

Asset transaction between the originator and the business undertaking

51. The asset transaction refers to any acquisition, leasing or disposal of an asset by the BU from or to the O. It also covers situations where the O contributes to the BU by contribution in kind, in which case the contribution is treated as an acquisition of an asset by the BU. If the profits sharing arrangement is a qualified IA, the asset transaction between the O and the BU will be disregarded for profits tax and property tax purposes according to section 22(4)(b) of the Schedule.

Investment return

52. Section 10 of the Schedule sets out the formula for calculating the investment return paid or payable in a period as follows:

$$A + B - C + D - E$$

A : the total amount of specified return paid or payable in the period

B : the specified proceeds of disposal paid or payable in the period

C : the specified acquisition cost paid or payable in the period

D : the total amount of any other sums paid or payable by the O to the BI in the period

E : the total amount of any incentive fee paid or payable by the BI to the O in the period

If the proceeds of disposal are applied towards the full or partial redemption of the alternative bonds, specified proceeds of disposal means the consideration for the disposal of the whole or part of the interest in the BU.

If the proceeds of disposal are applied towards the full or partial redemption of the alternative bonds, specified acquisition cost means the acquisition cost attributable to the whole or part of the interest in the BU disposed of.

53. Where the BHs have an option to redeem the alternative bonds after a certain date in the specified term, the funds for such early redemption are usually paid out of the proceeds from sale, by the BI to the O, of part of the specified asset, which is the BI's interest in the BU. Such sale of part of the specified asset to fund an early redemption will be reflected under items B and C in the investment return formula.

54. The O will, immediately before each scheduled payment date of the alternative bonds, calculate the BI's share of profits out of which a sum is set aside to meet the additional payments to the BHs and the excess is transferred to a reserve account. If the BI's share of profits in a period is not sufficient to cover the additional payments, a sum will be transferred out of the reserve account to meet the shortfall. At the end of the specified term, pursuant to the BI's waiver, the O will be allowed to keep any balance in the reserve account as an incentive fee. The incentive fee can be included under Item E and deducted from the investment return if the waiver in favour of the O is either:

- (a) mandatory and provided in the offering document of the alternative bonds; or
- (b) discretionary and provided in the offering document of the alternative bonds but the BI has executed, at the commencement of the ABS, an irrevocable waiver of any excessive profits.

Items D and E in section 10 are intended to cover the transfers from and to the reserve account.

55. The following examples illustrate the working of the provisions relevant to profits sharing arrangements and the calculation of investment return under profits sharing arrangements.

Example 13

On 1 October 2103, Company-O and Company-BI formed BU-HK in which both had a 50% interest. Company-O contributed a parcel of land of \$800 million as capital in specie whereas Company-BI contributed bond proceeds of \$800 million as cash capital. They would share the profits and losses equally and Company-BI would pay profits in excess of 4% to Company-O as incentive fees. Company-O undertook to acquire Company-BI's interest in BU-HK in two stages: \$320 million for 40% on 30 September 2017 and \$480 million for 60% on 30 September 2019 (i.e. the maturity date of the alternative bonds). Company-BI would use the proceeds of disposal to redeem the alternative bonds at par.

The specified proceeds of disposal would be: \$320 million on 30 September 2017 and \$480 million on 30 September 2019. The specified acquisition costs would be: \$320 million on 30 September 2017 and \$480 million on 30 September 2019.

Example 14

On 1 January 2014, Company-BI and Company-O formed BU-HK in which they had 75% and 25% interest respectively. Company-BI issued \$600 million of trust certificates to raise funds for its capital in BU-HK while Company-O contributed expertise and management skills. The profits sharing ratio was: Company-BI 99%; Company-O 1%. Should the specified return payable to Company-BI exceed the annual distributions, subject to a maximum rate of 5% per annum, payable to Companies-BH, Company-BI would pay the excess as an incentive fee to Company-O at the end of the specified term. Should the specified return fail to cover the annual distribution, Company-O would withdraw funds from a reserve account to cover the shortfall.

Company-BI agreed to sell its interest in BU-HK on 31 December 2016 to Company-O at market price and use the proceeds of disposal to redeem the trust certificates. The market price of BU-HK on 31 December 2016 was expected to be \$800 million and the profits generated from BU-HK during the specified term would likely be as follows:

Relevant Period	Profits of BU-HK \$m	Company-BI's Specified Return \$m	Company-BI's Aggregated Return \$m
1.1.2014 to 31.12.2014	40	39.6	39.6
1.1.2015 to 31.12.2015	30	29.7	69.3
1.1.2016 to 31.12.2016	40	39.6	108.9

The investment returns paid or payable in the relevant periods would be expected as follows:

Relevant Period	A \$m	+ B \$m	- C \$m	+ D \$m	- E \$m	= IR \$m
1.1.2014 to 31.12.2014	39.6	0	0	0	9.6 ^(a)	= 30
1.1.2014 to 31.12.2015	69.3	0	0	0.3 ^(b)	9.6	= 60
1.1.2014 to 31.12.2016	108.9	600 ^(c)	600	0.3	19.2	= 90

Notes:

- (a) \$39.6m – \$30m = \$9.6m
- (b) \$30m – \$29.7m = \$0.3m
- (c) \$800m × 75% = \$600m

Purchase and sale arrangement

56. The provisions in section 8 of the Schedule which relate to purchase and sale arrangements are intended to cover murabaha structures. If an arrangement satisfies the conditions therein, it will be regarded as a purchase and sale arrangement.

Specific features

57. Purchase and sale arrangements with fixed rate structures are

covered in section 8(2) of the Schedule whereas purchase and sale arrangements with floating rate structures are covered in section 8(3) and (4) of the Schedule.

58. In a fixed rate structure, the BI:

- (a) uses the bond proceeds to acquire, at the commencement of the specified term, an asset from a third party, with the acquisition cost (i.e. purchase price) of the asset paid immediately; and
- (b) immediately disposes of, on deferred payment terms, in a lump sum or by instalments, the asset to the O at a markup to generate gains.

The O then either disposes of the asset immediately to another third party against immediate payment or retains the asset for its own use.

59. In a floating rate structure, there is a series of acquisitions and disposals. The acquisition and disposal by the BI and onward disposal of the asset by the O occur at the commencement of the specified term and on each date, except for the last date, on which an additional payment is payable under the BA in the specified ABS. Aside from the first acquisition, the BI uses the proceeds of disposal of the asset of the preceding acquisition to make the next acquisition. Unlike the fixed rate structure, the O in a floating rate structure will not retain the asset for its own use.

60. In both structures, the third party from whom the BI acquires the asset may be a broker, a commodity supplier or any other person while the asset may be a commodity as found in floating rate structures. Section 8 would cover cases where the BI appoints the O as its buying agent or the O appoints an agent to undertake the asset or commodity transactions. However, cases where the BI acquires an asset from the O will be excluded. Further, cases where the BI acquires an asset from an associate of the O and then immediately sells the asset onward to the O who then sells it back to that associate will not fall into this type of arrangements. This is because of the “another third party” requirement in section 8(2)(c)(i) and 8(4)(c) of the Schedule.

61. Under this arrangement, each asset acquired and disposed of by the BI is, from the acquisition until the disposal, the specified asset.

The originator

62. The O is the person to whom the BI disposes of the specified asset immediately upon its acquisition as described in section 8(2)(b) and (4)(b) of the Schedule.

The markup

63. This is the markup added by the BI to the acquisition cost of the specified asset for disposal to the O as described in section 8(2)(b)(i) and 4(b)(i) of the Schedule.

Specified asset transaction between the originator and the bond issuer

64. It means the disposal or each disposal of the specified asset by the BI to the O as explained in section 8(6) of the Schedule. The specified asset transaction will be disregarded for profits tax purpose according to section 22(3)(a) of the Schedule if the purchase and sale arrangement is a qualified IA.

Investment return

65. Section 11 of the Schedule sets out the formula for calculating the investment return paid or payable in a period as follows:

A + B

- A :
 - (i) the markup, or part of it, paid or payable in the period in a fixed rate structure; or
 - (ii) the total amount of the markups paid or payable in the period in a floating rate structure;
- B : the total amount of any other sums paid or payable by the O to the BI in the period.

66. The markup or markups are pre-determined at the start of the specified ABS or at the preceding additional payment dates in floating rate

cases. As such, the markup or the aggregate of markups paid or payable should be equal to the bond return paid or payable.

67. The following examples illustrate the working of the provisions relevant to purchase and sale arrangements and the calculation of investment return under purchase and sale arrangements.

Example 15

On 1 April 2014, Company-BI purchased from a third party commodity supplier Commodity C with bond proceeds of \$600 million and sold the same to Company-O on spot delivery and deferred payment terms at a price of \$690 million payable by an annual instalment of \$330 million payable on 31 March 2015 to 2017 inclusive. Company-O immediately sold Commodity C for \$600 million on spot delivery and spot payment terms.

This is a purchase and sale arrangement with a fixed rate structure. The markup of \$90 million (\$690m-\$600m) represents the fixed rate interest payable to the BHs over the specified term. The acquisition and disposal by Company-BI to Company-O on deferred payment terms and the onward disposal by Company-O on immediate payment terms serve two purposes: to fix the markup for funding the payment of periodic distribution and to pass the funds representing the bond proceeds to Company-O. It was expected that the investment returns paid or payable in the relevant periods would be as follows:

Relevant Period	A \$m	+ B \$m	= IR \$m
1.4.2014 to 31.3.2015	30	0	= 30
1.4.2014 to 31.3.2016	60	0	= 60
1.4.2014 to 31.3.2017	90	0	= 90

Example 16

On 1 April 2014 and on each annual distribution date (except the last one), Company-BI would purchase Commodity D from a third party commodity supplier at \$600 million on spot delivery and spot

payment terms and sell the same on spot delivery and deferred payment terms at a price of \$600 million plus a markup equal to 1-year LIBOR plus 1% payable on the next annual distribution date. On each purchase, Company-O would immediately sell Commodity D to another third party for \$600 million on spot delivery and spot payment terms.

This is a purchase and sale arrangement with a floating rate structure. The markups represent the floating rates of interest payable to the BHs over the specified term. The acquisition and disposal by Company-BI on the closing date and on each periodic distribution date (except the last one) and onward disposal by Company-O serve two purposes: to fix the markups for funding the payments of the respective periodic distributions and to pass the funds representing the bond proceeds to Company-O.

Assuming the 1-year LIBOR on 1 April of 2014, 2015 and 2016 are 3%, 3.5% and 3.2% respectively, it was expected that the investment returns paid or payable in the relevant periods would be as follows:

Relevant Period	A \$m	+ B \$m	= IR \$m
1.4.2014 to 31.3.2015	24.0 ^(a)	0	= 24.0
1.4.2014 to 31.3.2016	24.0 + 27.0 ^(b)	0	= 51.0
1.4.2014 to 31.3.2017	24.0 + 27.0 + 25.2 ^(c)	0	= 76.2

Notes:

- (a) $\$600m \times (3\% + 1\%) = \$24m$
- (b) $\$600m \times (3.5\% + 1\%) = \$27m$
- (c) $\$600m \times (3.2\% + 1\%) = \$25.2m$

Agency arrangement

68. The provisions in section 9 of the Schedule which relate to agency arrangements are intended to cover wakala structures. If an arrangement satisfies the conditions therein, it will be regarded as an agency arrangement.

Specific features

69. In an agency arrangement, the BI appoints the O as its agent while the O undertakes to:

- (a) use the bond proceeds to acquire the specified asset;
- (b) hold the specified asset until the end of the specified term;
- (c) manage the specified asset to generate the specified return (i.e. agreed or expected return); and
- (d) dispose of the specified asset, whether or not in stages, by the end of the specified term in return for the proceeds of disposal.

70. The BI will receive the agreed or expected return while the O will receive an agency fee and/or an incentive fee. In general, the income or gains generated which exceed the agreed or expected return will be retained by the O as the incentive fee.

71. The specified asset may be acquired from and sold to the O or a third party. It is usually a portfolio of shares or pool of assets which may be substituted or replaced during the specified term. Whether the replaced asset constitutes the whole or part of the pre-replacement asset, the replacing asset and the remainder asset must be subject to the specified ABS until any further replacement. Though the O undertakes to acquire, hold, manage and dispose of the asset in many cases, the BI may enter into the transaction directly as a principal where the asset is acquired from, or leased or sold to the O.

72. Though section 9(3) and (4) of the Schedule provide that management of the specified asset may include leasing, disposal and replacement, the scope of management activities can include a wide range of other incidental activities such as managing and collecting returns from the specified asset. The BI may appoint other agents to perform functions similar to those of paying agent, securities agent, facility agent, commodity trading agent, etc.

The originator

73. The O is the person whom the BI appoints as its agent to invest and

manage the bond proceeds raised under the BA in the specified ABS as explained in section 9(1)(a) and (1)(b) of the Schedule. This agency is distinguished from those sub-agency arrangements under which a sub-agent is appointed as an investment adviser or a custodian. Termination of the agency agreement between the O and the BI will cause termination of the specified ABS whereas termination of a sub-agency agreement will not.

Specified return

74. The specified return is the profits which the BI is entitled from the management of the specified asset as explained in section 9(1)(c) of the Schedule.

Specified asset transaction between the originator and the bond issuer

75. It means any acquisition, leasing or disposal of an asset as, or as part of, the specified asset by the BI (whether or not acting through the O as its agent) from or to the O as explained in section 9(7) of the Schedule. The specified asset transaction will be disregarded for profits tax and property tax purposes according to section 22(3)(a) of the Schedule if the agency arrangement is a qualified IA.

Investment return

76. Section 12 of the Schedule sets out the formula for calculating the investment return paid or payable in a period as follows:

$$A + B - C$$

- A : the total amount of specified return paid or payable in the period
- B : the total amount of any other sums paid or payable by the O to the BI in the period
- C : the total amount of agency fee and incentive fee paid or payable by the BI to the O in the period

77. Items B and C in section 12 are intended to cover the transfer from and to the reserve account. They are similar to items D and E in section 10 of

the Schedule which apply to profits sharing arrangements. The operation of the reserve account is similar to the explanations given in paragraph 54 above.

78. The following example illustrates the working of the provisions relevant to agency arrangements and the calculation of investment return under an agency arrangement.

Example 17

By an agency agreement, Company-BI appointed Company-O as its agent with power to invest proceeds of \$600 million raised from a trust certificate issuance in a portfolio of listed shares selected by Company-O in accordance with specified criteria to generate a return sufficient to fund the distributions to Companies-BH payable at 4% per annum. Company-BI agreed to waive any profits in excess of the 4% in favour of Company-O as an incentive fee at the end of the specified term. Company-O as Company-BI's agent acquired from itself a portfolio of listed shares, comprising shares in Company-L1 and Company-L2. After two years, the shares in Company-L1 were sold and replaced by shares in Company-L3.

Immediately before each periodic distribution date, Company-O paid Company-BI a sum equivalent to 4% of the outstanding principal amount of the trust certificates out of the profits derived from the portfolio during the year ending on the periodic distribution date and kept the balance of profits in a reserve account. If the profits derived in a particular year were insufficient to cover the periodic distributions to Companies-BH (i.e. less than 4%), Company-O would top up the deficit out of the reserve account.

At the end the specified term, Company-O purchased from Company-BI at market price the remaining portfolio of listed shares in Company-L2 and Company-L3. Company-BI used the proceeds of disposal to redeem the trust certificates held by Companies-BH.

In the trust certificate issuance, Company-BI was the conduit and Company-O was the borrower. Though Company-O sold to Company-BI its portfolio of listed shares in Company-L1 and

Company-L2, the payouts to Companies-BH from the portfolio were restricted to a fixed rate interest of 4%. Company-O retained control over the management of the portfolio and any shares in the portfolio undisposed of at the end of the arrangement were sold back to Company-O.

Example 18

On 1 April 2014, Company-O was appointed by Company-BI as agent under an agency arrangement to acquire a portfolio of shares with proceeds of \$600 million raised by Company-BI from a trust certificate issuance to generate a return sufficient to fund the distributions to Companies-BH payable at 5% per annum. Company-BI agreed to pay any return in excess of the annual distributions to Company-O at the end of the specified term as an incentive fee. On each annual distribution date, Company-O would pay a sum equivalent to 5% of the outstanding principal amount of the trust certificates to Company-BI out of the profits derived from the portfolio and keep the balance in a reserve account. At the end of the specified term, the balance in the reserve account would be paid to Company-O. Expected results from managing the portfolio of shares were as follows:

Relevant Period/Date	Management Activities
1.4.2014 to 31.3.2015	Collected \$36 million of dividends from Portfolio-1
31.3.2015	Derived \$660 million from sale of Portfolio-1
1.4.2015	Incurred \$600 million on purchase of Portfolio-2
1.4.2015 to 31.3.2016	Collected \$16 million of dividends from Portfolio-2
1.4.2016 to 31.3.2017	Collected \$18 million of dividends from Portfolio-2

Pursuant to a purchase and sale undertaking, it was agreed that Company-O would purchase Portfolio-2 from Company-BI at market price (expected to be \$576 million) on 31 March 2017.

The investment returns paid or payable in the relevant periods would be expected as follows:

Relevant Period	A \$m	+ B \$m	- C \$m	= IR \$m
1.4.2014 to 31.3.2015	36+60 ^(a)	0	66 ^(b)	= 30
1.4.2014 to 31.3.2016	36+60+16	14 ^(c)	66	= 60
1.4.2014 to 31.3.2017	36+60+16+18–24 ^(d)	14+36 ^(e)	66	= 90

Notes:

- (a) \$660m – \$600m = \$60m
- (b) \$(36 + 60)m – \$600m × 5% = \$66m
- (c) \$600m × 5% – \$16m = \$14m
- (d) \$600m – \$576m = \$24m
- (e) \$600m × 5% – (\$18m – \$24m) = \$36m

QUALIFYING CONDITIONS FOR BOND ARRANGEMENT

79. Qualified BAs are to be regarded as debt arrangements to which the special tax treatment under section 21 of the Schedule applies. Under section 13(1) of the Schedule, the BA in a specified ABS is a qualified BA if the specified ABS always complies with the following five conditions (even if the specified IA in the scheme is not a qualified IA):

- (a) the reasonable commercial return condition;
- (b) the BA as financial liability condition;
- (c) the Hong Kong connection condition;
- (d) the maximum term length condition; and
- (e) the arrangements performed according to terms condition.

Reasonable commercial return condition

80. The reasonable commercial return condition and the BA as financial liability condition ensure that the return from the alternative bond is economically equivalent to the return from a financial liability. The reasonable commercial return condition requires that both the “maximum total amount of the bond return that may be payable” and the “total amount of the bond return actually paid” in each period should not exceed a reasonable commercial return. For this purpose, a period is from the commencement of the specified term to each scheduled payment date or actual payment date on

which the additional payment or redemption payment may be payable or is actually paid.

81. The “maximum total amount of the bond return that may be payable” refers to the maximum possible amount of the bond return payable under the terms of the arrangement. The “total amount of the bond return actually paid” refers to the bond return actually paid in a period, including exceptional not-per-terms payments. Both the bond return payable and the bond return actually paid must not exceed the reasonable commercial return. Section 14(5) of the Schedule provides the formula for calculating the bond return paid or payable as follows:

$$(A - (B \times A / C)) + D$$

- A : the amount of the redemption payment or part of it that is paid or payable in the period
- B : the whole amount of the bond proceeds
- C : the whole amount of the redemption payment
- D : the total amount of additional payments paid or payable in the period.

82. The first part of the formula in brackets is to find out the amount of the premium or discount if there is partial or full redemption of the alternative bonds. In short, the formula for the bond return is: redemption payment – bond proceeds + coupon payments.

Example 19

An alternative bond of par value \$100,000 with a 2 year tenor was issued at \$98,000 and was redeemed at par. The holder received 4 half-yearly payments of \$1,000 each.

The bond return to the holder at the end of the specified term
= $\$100,000 - \$98,000 + 4 \times \$1,000 = \$6,000$.

If the bonds were redeemed in two equal instalments, the bond return to the holder at the end of first year
= $\$50,000 - (\$98,000 \times \$50,000/\$100,000) + 2 \times \$1,000$
= \$3,000.

83. The reasonable commercial return is not an arbitrary return set to restrict the number of BAs that could be qualified for the special tax treatment. Nor is it used to discriminate any BA offering higher return to its holders because of its potential risks of default. In applying the reasonable commercial return test, the alternative bonds should be compared to a hypothetical loan on similar terms and carrying similar risks. The return applicable to each case varies depending on the market condition at the time of issue, the terms of the bonds (e.g. exchangeable bonds normally carry a lower rate of return) and the credit rating of the O.

84. In general, investment in alternative bonds will carry a slightly greater risk than investment in conventional debt securities. The BHs have an indirect recourse only to the purchase undertaking executed by the O and cannot sue the BI for return of the capital sum. The reasonable commercial return for alternative bonds is likely to be higher compared with conventional debt securities.

85. As with any financial instrument, the pricing of alternative bonds will depend on the O's view of the market at the time of issue and "reasonable commercial return" may vary within a range. The purpose of the test is to exclude cases where:

- (a) the issue terms of the alternative bonds impose no upper limit on the amount of additional payments;
- (b) the additional payments and redemption payment are linked to profits (e.g. equity instruments); or
- (c) the fixed rate or the margin is blatantly above what would be reasonable and commercial for a debt security on similar terms carrying similar risks.

These cases indicate that the alternative bonds are not debt-like instruments.

86. The Commissioner will treat the condition as having been met if:

- (a) the fixed rate or benchmarked rate of the alternative bonds is comparable to the interest rate of a loan on similar terms carrying similar risks; and
- (b) the redemption and additional payments are made to the BHs according to the terms.

For issuances with step-down additional payments, if the interest rates in earlier periods fall within a reasonable range, the condition may also be accepted as having been met.

BA as financial liability condition

87. This condition requires that the BA:

- (a) is treated as a financial liability of the BI in accordance with the Hong Kong or the international accounting standards; or
- (b) would be treated as a financial liability of the BI if the BI applied the Hong Kong or the international accounting standards.

88. The term “financial liability” is defined in International Accounting Standard 32 as well as Hong Kong Accounting Standard 32. This definition includes a contractual obligation to deliver cash or another financial asset to another entity. As alternative bonds issued under a qualified BA are functionally equivalent to debt securities, the BI should prepare accounts according to their economic substance and recognise the BA as a financial liability if it adopts the Hong Kong Financial Reporting Standards (HKFRS) or the International Financial Reporting Standards (IFRS).

89. There may be cases where the BI uses other reporting standards because of the requirement imposed by its country of incorporation or constitution. The condition will also be treated as having been satisfied if the BI seeks an accounting opinion confirming that the BA in the specified ABS would be treated as a financial liability according to either the HKFRS or the IFRS.

90. An alternative bond which is exchangeable for shares would be treated as a hybrid instrument (i.e. a host contract plus an embedded derivative) for accounting purposes. Provided that the host contract represents a financial liability, the alternative bond will be partly treated as a financial liability and will thus satisfy the financial liability condition.

Hong Kong connection condition

91. The Hong Kong connection condition ensures that the alternative bonds eligible for debt treatment will have the requisite degree of nexus with Hong Kong in a way that it would help promote the Hong Kong sukuk platform. A specified ABS complies with the Hong Kong connection condition if alternative bonds issued under the BA in the scheme:

- (a) are listed on the Hong Kong Stock Exchange;
- (b) are issued in good faith and in the course of carrying on business in Hong Kong;
- (c) are marketed in Hong Kong; or
- (d) are lodged with and cleared by the Central Moneymarkets Unit of the Monetary Authority.

92. Where the alternative bonds are listed, it is expected that the listing status would be maintained throughout the specified term of the specified ABS. Where the alternative bonds are not listed, the condition is also satisfied if the alternative bonds are lodged with and cleared by the Central Moneymarkets Unit. Where the alternative bonds are neither listed nor cleared by the Central Moneymarkets Unit, the condition is also satisfied if they are marketed in Hong Kong or issued in the course of carrying on business in Hong Kong.

93. The word “marketed” usually carries the meaning of “to advertise, promote and offer for sale”. Where it is claimed that the alternative bonds are marketed in Hong Kong, genuine actions or activities should be undertaken to market the alternative bonds in Hong Kong by way of:

- (a) conducting promotional activities such as advertising; and
- (b) making an offer for sale such as issuing or distributing offering documents.

While facts and circumstances of each case will be considered in its totality, promotional activities alone may not be sufficient to satisfy this condition.

Maximum term length condition

94. The maximum term length condition requires that the specified term

of the specified ABS must not exceed 15 years. In other words, any delay of the disposal of the specified asset, even allowed under sections 18(2) or 28(2) of the Schedule, must not cause the specified term to exceed 15 years. The condition effectively limits the tenor of ABSs to 15 years.

Arrangements performed according to terms condition

95. The arrangements performed according to terms condition ensures that the actual performance of the BA and the specified IA during the specified term accords with the terms of the arrangements so as to prevent any abuse by delaying the disposal of the specified asset to an infinite period. A specified ABS complies with this condition if the BA and specified IA in the scheme are performed according to the terms of the arrangements as described in section 2 and sections 6 to 12 of the Schedule.

96. Section 18(2) of the Schedule allows a 30-day delay in disposing of the specified asset without breaching the condition. Under section 28(2) of the Schedule, the Commissioner may, when the other qualifying conditions are met, disregard a delay of more than 30 days if he is satisfied that there is a reasonable excuse.

Example 20

Company-BI issued alternative bonds with a specified term of 12 years. As a result of liquidity problem, Company-O unilaterally delayed the purchase of the specified asset from Company-BI at the end of the specified term for 28 days.

The condition would be treated as satisfied under section 18(2) of the Schedule. If the purchase was delayed for three months, section 28 of the Schedule would allow the Commissioner to treat the condition as having been satisfied. If the tenor of the alternative bonds had been 15 years, the “maximum term length condition” would not have been complied with.

Example 21

The specified asset of a 12-year agency arrangement was a

substantial holding in the share capital of a company listed in Country-F1. Upon redemption of the alternative bonds, Company-BI sold the holding to a buyer in Country-F2. The sale was blocked by the government of Country-F1 but was approved one year later.

The Commissioner may accept there is a reasonable excuse for the delay and treat the condition as having been satisfied according to section 28(2) of the Schedule.

97. Where the O is insolvent and fails to purchase the specified asset as stipulated in the purchase undertaking, the specified ABS may be terminated as a result. Termination may also arise where there is a total loss of the specified asset. In such circumstances, the Commissioner may treat the condition as having been satisfied.

QUALIFYING CONDITIONS FOR SPECIFIED INVESTMENT ARRANGEMENT

98. Qualified IAs are to be regarded as debt arrangements to which the special tax treatment under section 22 of the Schedule applies. Under section 13(2) of the Schedule, the specified IA in a specified ABS is a qualified IA if the BA in the specified ABS has always been a qualified BA (i.e. the BA is economically equivalent to a debt arrangement and has complied with the five conditions) and the specified ABS always complies with the following two conditions:

- (a) the BI as conduit condition; and
- (b) the IA as financial liability condition.

BI as conduit condition

99. The condition requires that both the “maximum total amount of the investment return that may be payable” and the “total amount of the investment return actually paid” to the BI in a period must not exceed respectively the “maximum total amount of the bond return that may be payable” and the “total amount of the bond return actually paid” to the BHs in the same period. For

this purpose, a period is from the commencement of the specified term to each scheduled payment date or actual payment date.

100. To determine whether the condition is met, the investment return paid or payable under the specified IA in a period will be compared with the bond return paid or payable under the BA in the specified ABS in that period. If the investment return paid or payable exceeds the bond return paid or payable, the condition is not met and the specified IA is not a qualified IA since it is not economically equivalent to a debt arrangement. In general, the investment return paid or payable should not be less than the bond return paid or payable since top-up payments will be made out of a reserve account or pre-arranged liquidity facilities. In case the O is insolvent, any reduction of the investment return payments will reduce correspondingly the bond return payments. Therefore, the investment return payments should not be less than the bond return payments.

Example 22

On 1 October 2013, Company-BI issued \$600 million trust certificates with a 3-year term under an ABS at a discount of 1%. The trust certificates would be redeemed at par by two equal instalments of \$300 million on 30 September 2015 and 2016 respectively. The trust certificates carried the right to receive distributions every 12 months of all income earned by Company-BI from the specified asset subject to a maximum rate of 5% p.a.

Company-BI used the bond proceeds to acquire from Company-O two commercial buildings, Building-1 and Building-2, which were leased back to Company-O each at a monthly rent of \$1.25 million. Company-O agreed to buy back Building-1 on 30 September 2015 at \$300 million which would be used to redeem half of the trust certificates. On 30 September 2016, Company-O would buy back Building-2 at \$300 million which would be used to redeem the remaining trust certificates. The trust would then be dissolved.

The investment returns paid or payable in the relevant periods would be expected as follows:

Relevant Period	A \$m	+ B \$m	- C \$m	+ D \$m	= IR \$m
1.10.2013 to 30.9.2014	30 ^(a)	0	0	0	= 30
1.10.2013 to 30.9.2015	60	300	297 ^(b)	0	= 63
1.10.2013 to 30.9.2016	75	600	594 ^(c)	0	= 81

Notes:

- (a) $\$1.25m \times 12 \times 2 = \$30m$
- (b) $\$300m \times 99\% = \$297m$
- (c) $\$300m \times 99\% + \$300m \times 99\% = \$594m$

Comparison of the investment return paid or payable and the bond return paid or payable for the same period would be as follows:

Relevant Period	IR \$m	BR^(a) \$m
1.10.2013 to 30.9.2014	30	30 ^(b)
1.10.2013 to 30.9.2015	63	63 ^(c)
1.10.2013 to 30.9.2016	81	81 ^(d)

Notes:

- (a) $BR = (A - (B \times A / C)) + D$ (i.e. redemption payment (full or part) – bond proceeds (full or part) + additional payments)
- (b) $\$0 + \$30m = \$30m$
- (c) $(\$300m - \$297m) + 2 \times \$30m = \$63m$
- (d) $(\$600m - \$594m) + (2 \times \$30m) + (1 \times \$15m) = \$81m$

Both the investment return and bond return are paid according to the terms of the arrangements. The BI as conduit condition is met as the “maximum total amount of the investment return that may be payable” and the “total amount of the investment return actually paid” to Company-BI in a period would not exceed respectively the “maximum total amount of the bond return that may be payable” and the “total amount of the bond return actually paid” to the BHs in the same period.

IA as financial liability condition

101. This condition requires that the specified IA:

- (a) is treated as a financial liability of the O in accordance with the Hong Kong or the international accounting standards; or
- (b) would be treated as a financial liability of the O if the O applied the Hong Kong or the international accounting standards.

102. If the BA of a specified ABS is a qualified BA and the BI merely acts as a conduit in the scheme, the O should account for the substance of the scheme and recognize the IA in the specified ABS as a financial liability if it adopts the HKFRS or the IFRS.

103. There may be cases where the O uses other reporting standards because of the requirement imposed by its country of incorporation or constitution. The condition will be treated as having been satisfied if the O seeks an accounting opinion confirming that the IA in the specified ABS would be treated as a financial liability according to either the HKFRS or the IFRS.

QUALIFIED BOND ARRANGEMENT AS DEBT ARRANGEMENT

Special tax treatment for qualified BA

104. Section 21 of the Schedule set out, for the purposes of the IRO, the special tax treatment for a qualified BA. The qualified BA is regarded as a debt arrangement and –

- (a) the bond proceeds are regarded as money borrowed by the BI from the BHs;
- (b) the additional payments are regarded as interest payable on the money borrowed by the BI from the BHs;
- (c) the BI is regarded as not being a trustee of the specified asset;
- (d) the BHs are regarded as not having any legal or beneficial interest in the specified asset;

- (e) if the rights in the alternative bonds are transferrable by delivery, the concessionary tax rate under section 14A or the exemption under section 26A of the IRO will apply provided that the conditions stipulated for the concession or exemption are satisfied;
- (f) if the rights in the alternative bonds are transferrable by delivery, the alternative bonds are regarded as certificates of deposit for the purposes of section 15(1)(j), (k) and (l) of the IRO, and the making of redemption payment for the alternative bonds is regarded as the redemption on maturity or presentment of certificates of deposit;
- (g) the additional payments are accorded the same tax treatment under section 16(2)(f) of the IRO as interest payable on conventional bonds;
- (h) the alternative bonds are regarded as “bonds” within the definition of “securities” for the purposes of section 20AC and item 1 of Schedule 16 of the IRO; and
- (i) the qualified BA is not regarded as a mutual fund, unit trust or similar investment scheme for the purposes of section 26A of the IRO.

QUALIFIED INVESTMENT ARRANGEMENT AS DEBT ARRANGEMENT

Special tax treatment for qualified IA

105. Section 22 of the Schedule set out, for the purposes of the IRO, the special tax treatment for a qualified IA. The qualified IA is regarded as a debt arrangement and –

- (a) the acquisition cost of the specified asset, which is funded by the bond proceeds from the BA, is regarded as money borrowed by the O from the BI;
- (b) the investment return payable is regarded as interest payable on the money borrowed by the O from the BI;
- (c) the BI is regarded as not having any legal or beneficial interest in the specified asset;

- (d) any “specified asset transaction between O and BI” is disregarded;
- (e) the specified asset, or part of it, acquired by the BI from a third party is regarded as acquired by the O directly from the third party;
- (f) the specified asset, or part of it, disposed of by the BI to a third party is regarded as disposed of by the O directly to the third party;
- (g) the income, expenditure, profits, gains or losses arising from the specified asset are regarded as those of the O;
- (h) the investment return, though constituting consideration payable for the right of use of land or buildings, is regarded as not being consideration for the purposes of section 5B of the IRO; and
- (i) the alternative bonds are regarded as debentures or instruments and the BI is treated as an associated corporation of the O for the purpose of section 16(2)(f)(iii) of the IRO.

In an issuance programme of alternative bonds, the BI will not be regarded as an associated corporation of the O if not all ABSs are or are intended to be specified ABSs, or if not all specified ABSs comply or are intended to comply with the reasonable commercial return condition and the BI as conduit condition.

106. Where the qualified IA involves an interest in a BU as the specified asset, then for the purposes of the IRO –

- (a) the BU and any acquisition or disposal of an interest in the BU are disregarded;
- (b) any “asset transaction between O and BU” is disregarded;
- (c) any asset acquired by the BU from a third party is regarded as acquired directly by the O from that third party;
- (d) any asset disposed of by the BU to a third party is regarded as disposed of directly by the O to that third party;
- (e) any other business activities carried on by the BU during the specified term are regarded as business activities carried on by the O directly; and

- (f) the income, expenditure, profits, gains or losses arising from an asset held by, or other business activities carried on by the BU are regarded as those of the O.

Example 23

Continue with the case in Example 14. The profits sharing arrangement was expected to meet the seven conditions in section 13(1) and (2).

Since the profits sharing arrangement is a qualified IA, it will be regarded as a debt arrangement under section 22(2) of the Schedule and –

- (a) the sum of \$600 million is regarded as money borrowed by Company-O from Company-BI according to section 22(2)(a) of the Schedule;
- (b) the investment return of \$30 million is regarded as interest paid by Company-O to Company-BI for each of the years ended 31.12.2014, 31.12.2015 and 31.12.2016 according to section 22(2)(b) of the Schedule;
- (c) the contribution of \$600 million by Company-BI to the BU-HK as capital and the disposal by Company-BI to Company-O of its interest in the BU-HK at \$600 million on 31.12.2006 are disregarded according to section 22(4)(a); and
- (d) the profits of \$40 million, \$30 million and \$40 million generated from BU-HK for the years ended 31.12.2014, 31.12.2015 and 31.12.2016 respectively are regarded as profits of Company-O according to section 22(4)(f) of the Schedule.

107. Under the special tax treatment, the additional payments in a BA as well as the investment return in an IA are treated as interest payable by the BI to the BHs and the O to the BI respectively. The taxability and deductibility of such additional payments as well as the investment return will be subject to the same provisions in the IRO applicable to interest income/expenditure. Details of the tax treatment can be found in Departmental Interpretation and Practice Notes No. 13 (Profits Tax – Taxation of Interest Received),

Departmental Interpretation and Practice Notes No. 13A (Profits Tax – Deductibility of Interest Expense) and Departmental Interpretation and Practice Notes No. 21 (Locality of Profits).

DISQUALIFICATION AND WITHDRAWAL OF SPECIAL TAX TREATMENT

Non-qualifying transactions

108. The special tax treatment accorded to a qualified BA or a qualified IA is a conditional tax treatment. If the IA or BA eventually falls short of complying with the qualifying conditions and is not to be regarded as a debt arrangement, the nature of transactions involved will be determined after taking into account their substance and legal form.

109. Section 13(3) of the Schedule provides that an arrangement is to be regarded as never having been a qualified BA on the occurrence of a “BA disqualifying event” at any time during the specified term. Similarly, section 13(4) of the Schedule provides that an arrangement is to be regarded as never having been a qualified IA on the occurrence of an “IA disqualifying event” at any time during the specified term.

Retrospective effect

110. The consequences are that the special tax treatment under sections 21 or 22 of the Schedule applied to an arrangement is to be withdrawn retrospectively from the commencement of the specified term. That would mean the tax liabilities of the BI or the O for all relevant years of assessment have to be re-computed, and additional assessments, assessments or reassessments are to be issued.

Disqualifying events

111. A “BA disqualifying event”, as defined under section 13(5) of the Schedule, means:

- (a) the ABS is not a specified ABS at any time during the specified term; or

- (b) the specified ABS fails to comply with any of the five qualifying conditions for a BA at any time during the specified term.

112. An “IA disqualifying event”, as defined under section 13(5) of the Schedule, means:

- (a) the ABS is not a specified ABS at any time during the specified term;
- (b) the specified ABS fails to comply with any of the five qualifying conditions for a BA at any time during the specified term (i.e. the BA in the specified ABS is not a qualified BA); or
- (c) the specified ABS fails to comply with any of the two qualifying conditions for a specified IA at any time during the specified term.

That is to say, in the event that a BA in a specified ABS is disqualified, the IA in the specified ABS is also disqualified. This is, however, not vice versa.

Example 24

In a specified ABS, although the BI as conduit condition and the IA as financial liability condition were satisfied, the reasonable commercial return condition was not complied with.

The specified ABS’s failure to meet the reasonable commercial return condition rendered the BA not a qualified BA and the IA not a qualified IA.

Example 25

In a specified ABS, the BI as conduit condition was failed near the end of the term. It, however, met all other conditions throughout.

The specified ABS’s failure to meet the BI as conduit condition rendered the specified IA not a qualified IA. However, this did not affect the status of the BA which remained to be a qualified BA.

Example 26

In a specified ABS, 99% of the alternative bonds issued were subscribed by one BH. The IA of the ABS was a profits sharing arrangement. The ABS complied with the seven qualifying conditions. Therefore, its BA and IA had been regarded as a qualified BA and a qualified IA respectively. At the end of the specified term, the BI, instead of waiving the excessive profits in favour of the O according to the terms of the scheme, distributed all excessive profits to the BHs.

Two BA disqualifying events occurred. The scheme failed to comply with the reasonable commercial return condition and the arrangements performed according to terms condition. Both the BA and the IA are to be regarded as never having been a qualified BA and never having been a qualified IA respectively. The special tax treatment accorded to them would be revoked.

113. Section 28(2) of the Schedule empowers the Commissioner to disregard a delay of more than 30 days in disposing of the specified asset where there is a reasonable excuse in relation to the “arrangements performed according to terms” condition. Apart from that, the Amendment Ordinance does not provide for any other remedies for non-compliance. Once a disqualifying event occurs, the disqualification is retrospective. The BA or the IA in the specified ABS will remain an unqualified BA or IA even if the scheme complies with the specified conditions later and throughout the rest of the specified term.

OBLIGATION TO INFORM DISQUALIFYING EVENT

Informing the Commissioner in writing

114. Generally, the obligation is on the BI for a BA, and on the BI or the O for an IA. They are required, under section 26 of the Schedule, to notify the Commissioner in writing of a disqualifying event within 30 days. Failure to notify a BA disqualifying event or an IA disqualifying event will be treated as a failure to comply with section 51(2) of the IRO and will entail penalties under sections 80 or 82A of the IRO.

115. However, notification will not be required if:

- (a) the assessment or assessments for any year of assessment, made on the basis that the claim that the BA or IA is a qualified BA or IA is not accepted, have become final and conclusive under section 70 of the IRO;
- (b) the specified assessment or assessments for any year of assessment, made on the basis that the BA or IA is disqualified because of an earlier disqualifying event, have become final and conclusive under section 70 of the IRO.

RECORD KEEPING AND LIMITATION PERIODS

Sections 51C and 51D

116. Section 51C(1) of the IRO requires that business records must be kept for a period of not less than 7 years after the completion of the transactions, acts or operations to which they relate. Section 51D(1) of the IRO has similar requirement for rental records. These provisions ensure that the records relevant to the tax return must be kept until the period of limitation for raising tax assessment runs out (i.e. the 6-year period under section 60 of the IRO).

117. The tax regime for ABS allows alternative bonds to have a specified term up to 15 years. Revocation of the special tax treatment is retrospective from the commencement of the specified term. To align with the specified term, section 25 of the Schedule modifies section 51C of the IRO by requiring the BI and the O to retain records in respect of the specified ABS to the later of :

- (a) the expiry of 7 years after the completion of the transactions, acts or operations to which they relate; or
- (b) the expiry of 3 years after the end of the specified term of the scheme.

Failure to do so will be treated as a failure to comply with section 51C and will entail penalties under section 80 of the IRO.

118. However, the modified record-keeping period ceases to apply if:
- (a) the assessment or assessments for any year of assessment, made on the basis that the claim that the BA or IA is a qualified BA or IA is not accepted, have become final and conclusive under section 70 of the IRO;
 - (b) the specified assessment or assessments for any year of assessment, made on the basis that the BA or IA is disqualified, have become final and conclusive under section 70 of the IRO.

Section 60

119. To align with the specified term which is up to 15 years, section 27(3) of the Schedule modifies section 60 of the IRO by allowing the limitation periods to run after the expiry of the year of disqualification of a BA/IA if that year falls after the year of assessment.

Section 79

120. Similarly, section 79 is modified by section 27(5) of the Schedule to extend the time period for refund in case of disqualification. The period of six years is to run after the expiry of the year of disqualification if that year falls after the year of assessment.

Example 27

The lease arrangement in a qualified IA had a specified term of 10 years from 2014/15 to 2023/24. Special tax treatment under sections 21 and 22 would be granted to both the BA and the IA for years 2014/15 to 2023/24.

Should a BA disqualifying event occur in 2018/19, both the BA and IA would be disqualified and the special tax treatment would be withdrawn retrospectively from 2014/15. Assessments and additional assessments in respect of years 2014/15 to 2017/18 would be raised on the BI before the end of 2024/25. Assessments and additional assessments in respect of years 2018/19 to 2024/25 would

be raised on the BI before the end of six years after the end of the year of assessment. The additional payments to the BHs might be considered as dividends not subject to profits tax under section 26 of the IRO. The limitation period for any refunds to the BH, if any, in respect of years 2014/15 to 2017/18 would be extended to the end of 2024/25 whereas the limitation period for any refunds to the BH, if any, in respect of years 2018/19 to 2023/24 would be six years after the end of the year of assessment.

OBJECTIONS AND APPEALS

Objections to all specified assessments

121. The provisions in the IRO relating to a notice of assessment, appeal and other proceedings apply to specified assessments and any tax charged made under the modified section 60 or 79 of the IRO. However, section 27(8) of the Schedule provides that where the BI or the O objects to a specified assessment for any year of assessment, disputing the disqualification of the BA or IA, the objection is treated as objections to all specified assessments made for all years of assessment because of that disqualification.

ADVANCE RULINGS

Application and required information

122. Generally, where a person intends to enter into a specified ABS as the O and claims that the specified IA is a qualified IA, the person may make an application for an advance ruling. The Commissioner requires maximum disclosure in connection with requests for advance rulings. The request for an advance ruling must contain the information and documents as listed in paragraph 19 of Departmental Interpretation and Practice Notes No. 31 (Advance Rulings). The information of the specified ABS and details of each type of specified IA required to be provided are set out in the Appendix.

123. Requests for an advance ruling should be made well ahead of the closing date of the contemplated specified ABS. To process an application, a

minimum period of 8 weeks will generally be required. However, the Commissioner will not be bound by such period if the application does not contain all material information required for its processing.

LOANS (AMENDMENT) ORDINANCE 2014

Government bond programme

124. The Loans (Amendment) Ordinance 2014 has amended section 26A(1)(c) of the IRO to allow additional payments and disposal gains derived from any alternative bonds issued in connection with the Government Bond Programme to enjoy the same profits tax exemption as that currently applicable to the interest payments and disposal gains in relation to conventional Government Bonds. That is, profits of any corporation or other person chargeable to profits tax shall not include:

- (a) additional payments paid or payable on an alternative bond issued in connection with a borrowing by the Government within the meaning of section 2A(2) of the Loans Ordinance; and
- (b) any profit on the sale or other disposal of, or on the receipt of redemption payment for, such an alternative bond.

DOUBLE TAXATION AGREEMENTS

Interest article

125. Under sections 21 and 22 of the Schedule, the qualified BA and qualified IA in a specified ABS are regarded as debt arrangements though their legal form may not be a loan. Thus, the definition of “interest” in the Interest Article of Double Taxation Agreements entered into by Hong Kong should be applicable to additional payments and investment return made under qualified BAs and qualified IAs.

Appendix

Advance Ruling Application - Required Information and Documents

1. Provide or describe:
 - (a) the structure of the alternative bond scheme (with a diagram);
 - (b) the terms of the alternative bond scheme showing: the issue date; the size of alternative bonds; the investment arrangement; the trust assets; the issue rating; the listing; the tenor; the pricing; the date of distribution; the maturity;
 - (c) the economic effect that the scheme intends to achieve and the use of the bond proceeds; and
 - (d) the name of all the parties involved in the scheme, showing: the manager; the alternative bond issuer; the trustee; the obligor/guarantor; the Sharia advisor.
2. Provide a copy of the offering circular, prospectus or issuing document in respect of the alternative bonds issued or to be issued under the alternative bond scheme.
3. Provide a copy of the base prospectus or issuing document, copies of the supplements and final terms, and a copy of the programme agreement if the alternative bond scheme forms part of an issuance programme.
4. Explain why the scheme is an alternative bond scheme within the meaning of section 2 of the Schedule.
5. Explain why the bond-issuer is a special purpose vehicle within the meaning of sections 1 and 3(1) of the Schedule.
6. Identify the originator of the scheme within the meaning of section 2(4) of the Schedule.

7. Confirm the type of specified investment arrangement involved and explain how the arrangement meets the specific features in section 6, 7, 8 or 9 of the Schedule as the case may be.
8. List the transaction documents which will be executed under the scheme. Describe each document with sufficient details and state the governing law.
9. Provide a copy of each of the transaction documents in relation to the alternative bond scheme.
10. Submit a copy of each of the following transaction documents in relation to the specified investment arrangement and other relevant agreements or documents in connection therewith:
 - (a) Lease arrangement
Trust deed, purchase agreement, lease agreement, service agency or management agreement, sale undertaking, purchase undertaking and substitution undertaking.
 - (b) Profits sharing arrangement
Partnership or joint venture agreement, management agreement, purchase undertaking, sale undertaking and agreements relating to the assets of the venture (e.g. asset purchase agreement).
 - (c) Purchase and sale arrangement
Purchase and sale agreements and buying agency agreement.
 - (d) Agency arrangement
Agency agreement, asset buying agreement, purchase undertaking, sale undertaking and substitution undertaking.
11. List out the transaction documents which are in addition to those executed in an economically equivalent conventional bond scheme. Explain the reasons for executing the additional transaction documents and state the intended economic outcome of each additional transaction.

12. Explain how the bond arrangement in the alternative bond scheme will comply with each of the following conditions throughout the specified term:
 - (a) the reasonable commercial return condition;
 - (b) the bond arrangement as financial liability condition;
 - (c) the Hong Kong connection condition;
 - (d) the maximum term length condition; and
 - (e) the arrangements performed according to terms condition.
13. Explain how the investment arrangement in the alternative bond scheme will comply with the following two additional conditions throughout the specified term:
 - (a) the bond-issuer as conduit condition; and
 - (b) the investment arrangement as financial liability condition.
14. If the alternative bond scheme forms part of an issuance programme and the bond-issuer is not an associated corporation of the originator, submit details of the programme, explaining whether each of the other schemes under the programme:
 - (a) is or will be a specified alternative bond scheme; and
 - (b) complies or will comply with the reasonable commercial return condition and the bond-issuer as conduit condition.