



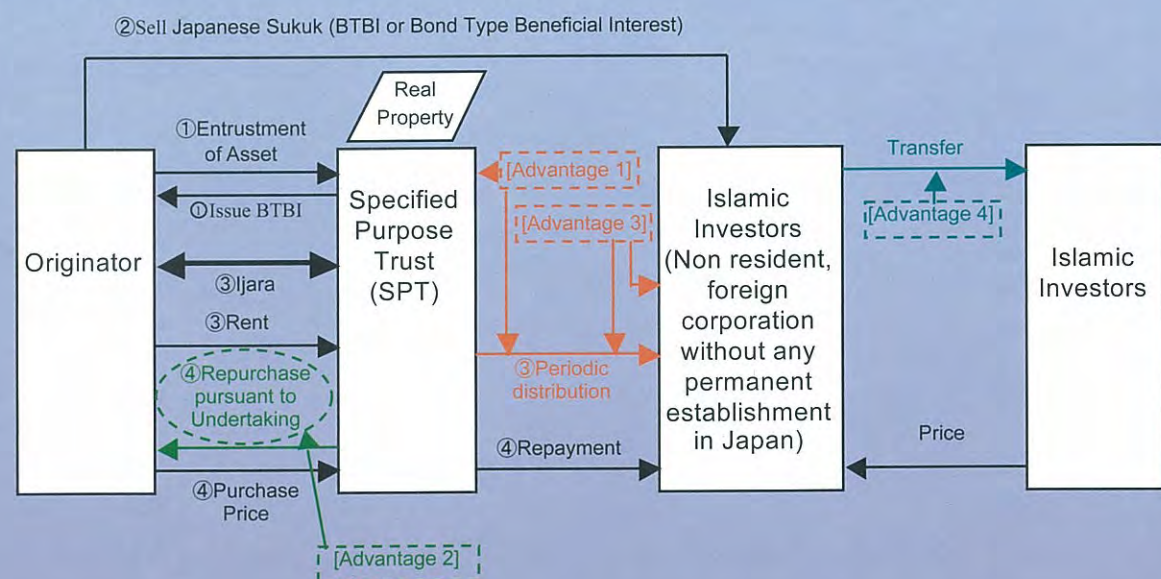
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ISLAMIC FINANCING IN JAPAN – CREATION OF JAPANESE VERSION OF SUKUK

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The act of amending the Asset Liquidation Law and the Tax Special Measurement Law was passed by the House of Councillors of the National Diet of Japan in May 2011. The purpose of the amendment is to encourage the issuance by Japanese companies of the Sukuk to foreign Islamic investors and boost the development of the Japanese capital market.

In many jurisdictions, one of the challenges in issuing the Sukuk is to ensure that the Sukuk would not be treated unfavorably in terms of taxation, in comparison with conventional bonds. Pursuant to the new legislation, if the beneficial interests in a trust issued under the scheme as illustrated by the diagram below according to the Asset Liquidation Law (such trust is defined in the Law as "Specified Purpose Trust" or "SPT") provide the distributions of a fixed amount (or a benchmark (e.g. LIBOR) plus a fixed amount), then the trustee of the SPT and the holders of such beneficial interests (such beneficial interests are defined in the Law as "Bond Type Beneficial Interests" or "BTBI") will be granted certain tax advantages as set forth below, provided certain requirements provided in the Tax Special Measurement Law are met.



Legend:

1. An originator (the "Originator") entrusts its real property (the "Trust Asset") to a trustee and in exchange for the entrustment, Specified Purpose Trust issues the Bond Type Beneficial Interests (the "Japanese Sukuk") to the Originator.
2. The Originator sells the Japanese Sukuk to the investors.
3. The SPT enters into the lease (*ijara*) agreement with the Originator who pays the rents, which are applied to the periodic distributions to the investors.
4. At the maturity of the Japanese Sukuk, the Originator repurchases the Trust Asset from the SPT pursuant to the purchase (or sale) undertaking and the amount paid for the repurchase is applied to the redemption of the Japanese Sukuk.

The new legislation has provided four tax advantages to the Japanese Sukuk.

Advantage 1:

In general, a taxpayer of a trust is a beneficiary of the trust. In the case of the Japanese Sukuk, however, the SPT is subject to corporate taxation and the amount distributed to the holders of the Japanese Sukuk is regarded as deductible expense for the SPT's corporate tax purpose.

Advantage 2:

In general, the real estate transactions are subject to the registration tax and the real estate acquisition tax. In the case of the Japanese Sukuk, however, the repurchase of the Trust Asset is not subject to those taxes.

Advantage 3:

In general, the distributions from the trusts subject to corporate taxation are taxable income of the investors (the double taxation). In the case of the Japanese Sukuk, however, the distributions under the Japanese Sukuk are not subject to the withholding tax.

Advantage 4:

In general, the gain from a transfer of a beneficial interest in the trust which is subject to the corporate tax and which asset is constituted by a domestic real estate is subject to the capital gain tax. In the case of the Japanese Sukuk, however, the capital gain tax is not imposed on the transfer of the Sukuk by a non-resident.

The new legislation is expected to encourage the issuance of the Japanese version of Sukuk but there are still some issues yet to be resolved.

1. Whereas the scheme of the Japanese Sukuk is envisaged to be used in the real estate financings, is it permitted by Shariah to use the proceeds from the issuance of the real property based Sukuk for the purpose other than the acquisition and development of the property, such as reconstruction of the infrastructure which have been severely damaged by the earthquake this year?

In this regards, the proceeds from the issuance of the real property based Sukuk are derived from a sale transaction between the originator and the investors. One may argue that based on the sale transaction, the originator will own the proceeds as the consideration of the sale of sukuk and as such the originator can utilise the proceeds in accordance with the purpose of the issuance or otherwise as long as the payment obligation towards the investors are fulfilled.

However, if the proceeds shall be utilised by the originator for the purpose other than the purpose stipulated for the issuance of the sukuk, there is a high probability of failure on the part of the originator to complete the project which may lead to its inability to serve the periodical payment to the investors and this will trigger an event of default. In this instance and considering the Maqasid ash-Shariah (the objective of Shariah), one may further argue that utilising the proceeds for the purpose other than the purpose stipulated for the issuance of the sukuk can be questioned under the Shariah.

2. Whether the Bond Type Beneficial Interests under which only the fixed amount distributions are made are regarded as Sharia compliant products?

Based on the Shariah principles, fixed amount distributions shall be allowed in the case of *ijara* (lease) and *bay'* (sale transaction) based transactions. However, fixed amount distributions are not allowed in equity-based transactions such as *mudharabah* (profit sharing) and *musharakah* (partnership).

3. Because of the scarcity of the Muslim population in Japan, the Japanese Sukuk will be likely to be offered for sale in the foreign jurisdictions with large Muslim populations, such as Malaysia. How will the offering of the Japanese Sukuks in Malaysia be regulated?

Foreign or local corporations require the approval of the Securities Commission Malaysia ("SC") under the Capital Market and Services Act 2007 for issues, offers for subscription or purchase, making an invitation to subscribe for and purchase of sukuk.

Approvals in relation to the issuance or offer of sukuk from other regulatory bodies (such as the Controller of Foreign Exchange) must be obtained prior to the submission of the proposal to the SC. Applicable conditions (if any) imposed upon such regulatory bodies will continue to be in effect throughout the tenure of the sukuk.



A VISIT FROM THE LAND OF THE RISING SUN

Early in the month of July, the Firm welcomed a partner from a law firm based in Tokyo, Japan, Yoshitada Ogiso. Yoshitada is from an established law firm, City – Yuwa Partners, one of the leading law firms in Japan. His visit to Malaysia was to attend a conference held by the International Swaps and Derivatives Association ("ISDA") entitled: ISDA/IIFM Islamic Master Agreement Conference in Kuala Lumpur on 6 July 2011.

He made a short visit to the Firm to exchange information on Islamic Finance. Our Senior Partner, Azmi Mohd Ali, Partner and Head of the Global Financial Services and Islamic Banking Practice Group, Ahmad Lutfi Abdull Mutalip, Partner, Farhah Hayati Mamat and Associate, Ahmad Syahir Yahya, welcomed Yoshitada.

In addition to sharing about the unique culture of Japan, Yoshitada enlightened the hosts on the new legislative framework implemented in Japan on the issuance of Sukuk al-Ijarah under the Japanese laws. The new framework provides an equal footing with the conventional bond issuance to the Japanese version of Sukuk al-Ijarah. This further brought the discussion to possible ventures in opening up business opportunities pursuant to the new legislation, especially for Malaysian investors and sukuk players.

Yoshitada had also made a short presentation on the 2011 Tax Reform in Japan with the purpose of encouraging the issuance of a Japanese version of Sukuk al-Ijarah.

He explained further on the Tax Reform, which affected the Asset Liquidation Law that was enacted exclusively for asset securitisation and is widely used for asset-backed transactions. Another aspect of the Japanese legislation that was amended was the Tax Special Measurement Law for the purpose of providing certain tax advantages to Sukuk al-Ijarah that is issued pursuant to the amended Asset Liquidation Law.

Yoshitada further elaborated on the new concept introduced under the Asset Liquidation Law, in the scope of Special Bond Type Beneficial Interest. In describing the new structure of Sukuk al-Ijarah under the 2011 Tax Reform, he had also depicted a few case scenarios that elaborate further on the structure of the new Tax Reform of Japan and the issues that are connected with the new structure.

Yoshitada's visit to the Firm was indeed a memorable one which encourages the Firm's possible ventures and expansion in the Land of the Rising Sun in the near future.



L-R: Ahmad Lutfi, Ogiso Yoshitada, Azmi and Syahir