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ARTICLES

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ARTICLES

ON THE TIME LIMIT FOR PRESENTING EVIDENCE IN CHINESE CIVIL LITIGATION*

*Bao Bingfeng***

ABSTRACT

The time limit for presenting evidence in China has been considered to be one of the most theoretical and practical controversies in China's civil proceedings since their establishment. The enactment of a new Civil Procedure Law in 2012 and corresponding judicial interpretations signify greater flexibility in the timely filing of evidence. However, the time limit for presenting evidence still presents significant hurdles. The negotiation between parties to determine the deadline for producing proof is in name only, pre-trial procedures are inadequate, and sanctions and the judicial environment are not ideal. The civil procedure provisions in the United States, Germany, France and Japan regarding the time limit for presenting evidence are models for China. Therefore, in China, the effective operation of the time limit for presenting evidence would be furthered by improving pre-trial procedures, clarifying the standard for penalty and compensation procedures, and strengthening the obligation of judges to interpret these procedures, properly.

I. PRELIMINARY REMARKS

In civil litigation, the time limit for presenting evidence, a symbolic system introduced in the reform of civil trials in China, has functions such as improving the efficiency of litigation, balancing the defensive measures of the parties, and preventing the delay of litigation. However, the development of China's time limit has not achieved the expected legislative purpose. Therefore, it is important to study the cause of the malfunction of this mechanism, which not only matters to the evidence disqualification system but to the development of civil litigation procedures in China.

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** Associate Professor, China Southwest University of Political Science and Law; Visiting Scholar at Yonsei University.

II. THE ORIGIN OF THE TIME LIMIT FOR PRESENTING EVIDENCE IN CHINA

A. The Prototype

The time limit for presenting evidence demands that the parties prove their claims or refute the opposing evidence within a legally specified time; late evidence will suffer corresponding legal consequences. The Civil Procedure Law, promulgated in 1991, did not set a time limit, and the parties could submit evidence at any time. It allowed the parties to conduct evidence raids and delay proceedings, wasting judicial resources, and damaging judicial authority. Article 76 of the Opinions of the Supreme People's Court on Several Issues Concerning the Application of the Civil Procedure Law of the People's Republic of China (Opinions) stipulated in 1992: "[W]here a people's court cannot submit evidence for the moment, the people's court shall, on the basis of specific circumstances, determine a reasonable time limit for its commitment. The party in difficulty of timely producing proof shall apply to the court for an extension of time." This opinion has provided a prototype of the time limit for adducing evidence, but the results were not satisfactory because the legal consequences of late evidence were not provided and the time limit was not well defined.

B. Initial Revisions

On December 21, 2001, the Supreme People's Court promulgated Several Provisions on Evidence in Civil Procedure (Evidence Provisions). The Evidence Provisions specify the time limit for the parties to exercise their right of proof and the legal consequences of past-due proof, and mark the initial establishment of the mechanism of the time limit for producing evidence in China. The most important provision in the Evidence Provisions is Article 34:

> [T]he parties should be in the proof period to submit evidence to the people's court; the parties who do not submit within the time limit will be deemed as to waive

> this right. For the late-submitted evidence materials, unless the other party has agreed [to the late submission], the people's court will not allow cross-examination. On condition that the parties increase or change the request for litigation or propose a counterclaim, it shall be within the time limit for adducing proof.

However, the effect of the "time limit for adducing evidence" was far from public expectations. Doubts were raised among many scholars who believed that, due to the flaws of the time limit in not designing specific procedures, neither the efficiency of litigation nor substantive justice could be achieved.[1] Some scholars also believed that the disqualification of evidence as a consequence of late proof was too harsh.[2] Some scholars suggested that evidence disqualification was wrongly based on a time-limit theory.[3] The subsequent years of judicial practice witnessed a softening, even abandonment, of the time-limit procedure. Many judges hold that the use of the time-limit provisions has increased wrongly decided cases. Thus, significant evidence in a case shall be examined even when the party concerned did not timely produce it.[4] In all, these imperfections in the evidence provisions make modification of the provisions on the time-limit for adducing evidence imperative.

III. CHINA'S EXISTING PROVISIONS ON THE TIME-LIMIT FOR PRESENTING EVIDENCE

A. Amendment of the Civil Procedural Law

On August 31, 2012, the 28th Session of the 11th National People's Congress Standing Committee of China amended the Civil Procedure Law. Article 65 now stipulates that:

> A party shall provide evidence for its claims in a timely

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[1] Tian Pingan & Ma Dengke, *The Time Limit for Adducing Evidence of Cold Thinking*, 1 LAW FORUM 91 (2006).

[2] LIAO ZHONGHONG, CIVIL LITIGATION REFORM HOT ISSUES RESEARCH REVIEW (1991-2005) 590 (2006).

[3] Li Hao, *The Dilemma and Way of the Time Limit for Adducing Evidence*, 3 CHINA LAW 152 (2005).

[4] Higher People's Court of Jiangsu Province, *Report on the Application of Evidence Rules in Traditional Civil Cases*, 1 TRIAL STUDY 141 (2010).

> manner. A people's court shall, according to the claims of a party and the circumstances of the trial of a case, determine evidence to be provided by the parties and the time-limit for producing the evidence. Where it is difficult for a party to provide evidence within the time-limit, the party may apply to the people's court for an extension, and the people's court may appropriately extend the time-limit upon application of the party. Where a party provides any evidence beyond the time-limit, the people's court shall order the party to provide an explanation; and, if the party refuses to explain or the party's explanation is not acceptable, the people's court may, according to different circumstances, deem the evidence inadmissible or adopt the evidence but impose an admonition or a fine on the party.

This amendment of the article codifies the establishment a revised time-limit for adducing evidence.

The most striking aspect of the article is the legal consequences for late proof. The prior evidence provisions were widely criticized mainly because of overly-strict disqualification. The amendment relies on admonitions, fines and other sanctions as a replacement for disqualification; and, while it adheres to the necessity of regulating the time limit for proof, it appropriately weakens the effect of evidence disqualification.

There are two advantages of this revised language. Firstly, it encourages the parties to timely present evidence. Secondly, the alternative measure will not cause conflicts between substance and procedural due process, will protect the right-holders, and will allow the court to render a decision based on true facts.[5]

B. Introduction of Judicial Interpretation

On February 4, 2015, the "Interpretation of the Supreme People's Court on the Application of the Civil Procedure Law of the People's Republic of China" (Civil Procedure Interpretation) was officially announced. This is the longest judicial interpretation of the Supreme People's Court. Regarding the Civil Procedure Law, the Civil Procedure Interpretation has provided detailed

[5] Zhang Weiping, *Analysis on the Countermeasures of the Delay of Evidence in Civil Proceedings*,5 JURISTS 104 (2012).

provisions on the time limit for presenting adducing evidence.

C. Determination of Time Limit for Presenting Evidence

According to Article 99 of the Civil Procedure Interpretation, a people's court shall determine the time limit for parties to present evidence before the trial. It may be negotiated by the parties, subject to the approval of the people's court. The time limit for presenting evidence determined by a people's court shall not be less than fifteen days for a case under the formal procedure at the first instance, and shall not be less than ten days for a case under the procedure at the second instance in which a party provides new evidence. After the expiry of the time limit, where a party applies to provide rebuttal evidence, or to supplement and correct defects in the source, form, and other aspects of the existing evidence, a people's court may, in its discretion, re-determine the time limit, which is not subject to preceding provisions.

Two points are notable.

Firstly, when determining the time limit for presenting evidence, Article 33 of the Evidence Provisions provided that the people's court shall serve notice, at the same time as service of the notice of acceptance of the case and the notice of responding to the case, which clearly stipulates the time limit for presenting evidence and the consequences of past-due evidence. This means that the people's court in the admissibility stage determines the time limit for presenting evidence. The Civil Procedure Interpretation changed this practice and provided that the people's court should determine the time limit in the preparation stage. According to the provisions of the Civil Procedure Law, the pre-trial preparation stage is the period after the expiration of the period for the hearing. This change is mainly based on the following consideration. If the court determines the period of evidence at the case acceptance stage, the time limit for presenting evidence of the both parties will be inconsistent. The different time limit for presenting evidence may lead to procedural confusion.

Secondly, the court may re-determine, as appropriate, the time limit for presentation of the evidence only in cases where the parties need to provide rebuttal or supplementary evidence. Although the situations are broadened, compared to those in the Evidence Provisions, they cannot be arbitrarily expanded in

application. The so-called reinforcing evidence refers to evidence used to confirm or prove the authenticity of another piece of main evidence, establish its qualifications, or address defects to supplement or enhance its probative force.

D. Extension of the Time Limit for Producing Evidence

According to Article 100 of the Civil Procedure Interpretation, a party who applies for an extension of the time limit for producing evidence shall submit a written application before the expiration of the deadline. Where the grounds for the application are tenable, a people's court shall grant permission, appropriately extend the time limit for adducing evidence, and notify the other parties. The extended time limit for presenting evidence shall be applicable to other parties as well. Where the grounds are not tenable, the people's court shall not grant permission but notify the applicants of the denial.

This article is a procedural requirement on the extension of the period of proof. In understanding it, two points are important. Firstly, the court reviews the application to determine if the party's reasons are based on whether producing the evidence within the time limit is indeed difficult to carry out. These 'difficulties,' refer to objective obstacles; subjective reasons are not included.[6] Secondly, the court has the obligation to inform the applicant of the court's decision. The court shall inform the other parties when an extension is allowed.

E. Review of the Late Proof

In accordance with Article 101 of the Civil Procedure Interpretation, where a party provides any evidence beyond the time limit, the people's court shall order the party to provide an explanation and may request the party to provide supporting evidence for the application. Where a party provides evidence beyond the time limit for objective reasons or the opposite party does not raise any objection against the evidence provided, it shall not be deemed past due.

This article deals with the procedure for the court to review

[6] SHEN DEYONG, UNDERSTANDING AND APPLICATION OF THE JUDICIAL INTERPRETATION OF THE SUPREME PEOPLE'S COURT IN THE CIVIL PROCEDURE LAW 339 (2015).

the past-due evidence from a party and circumstances where it is not considered late. Two points are critical here. Firstly, the court requires reasons for the past-due submission of evidence to provide procedural safeguards for the parties. The purpose is, not to require the court to arrange separate debates and cross-examinations for the parties. It is emphasized, here, that the court should satisfy the basic requirements of procedural fairness in matters concerning the vital interests and procedural rights of the parties. Secondly, based on respect for the other party's rights in the proceedings, evidence produced by one party is not considered past due, as long as the opposing party does not object. If a party provides evidence beyond the time limit, it will lead to adverse consequences for the opposing party, and the abandonment of such litigation interests is an exercise of the right of disposition, which shall be respected by the court.

F. Legal Consequences of Late Proof

In accordance with Article 102 of the Civil Procedure Interpretation, past-due evidence provided by a party, deliberately or due to gross negligence, shall be deemed inadmissible by a people's court. However, evidence related to the basic facts of the case shall be deemed admissible by the people's court, and the court shall impose an admonition or a fine in accordance with relevant provisions. When the party has not acted deliberately or due to gross negligence, the evidence shall be deemed admissible by a people's court, and the party shall receive an admonition. Where a party requests that the opposing party compensate for the increased cost of transportation, accommodation, meals, lost labor, witness presentations, and other necessary expenses arising from the new evidence, the people's court may order compensation.

This article's consequences for past-due evidence sets out different responsibilities and consequences according to the degree of party's subjective fault. "Evidence related to the basic facts of the case" refers to the evidence concerning the basic facts of the case, which is past due but has probative force that requires review and determination by the court. The consequence of evidence disqualification is a responsibility provided in evidence law. Where the evidence's presentation is not delayed because of intentional or gross negligence or, regardless, the evidence is related to the basic facts of the case, and the delay of litigation may harm civil procedure but does not cause adverse results

according to the evidence laws, the court shall impose an admonition or fine on the party.

Apart from the extent of subjective fault of the party who has provided the past-due evidence, one party cannot be exempted from compensating the other party for the increased corresponding costs. Where the opposing party requests compensation for additional, necessary expenses arising from the late submission of the evidence, the court may allow them.

IV. COMPARATIVE RESEARCH ON THE TIME LIMIT FOR PRESENTING EVIDENCE

A. The United States

The civil trial court litigation of the United States can be divided into three parts: (1) pleading and response procedures, (2) pre-trial procedure, and (3) trial procedure. Just as its name implies, the pleading and response procedure is where the plaintiff and defendant exchange their complaint and answer or other response. By submitting the complaint and response, both parties provide preliminary but relevant information, allowing preparation before the trial. Preparation before trial is also called pre-trial procedure, which has been playing an important role as a vital phase in U.S. civil litigation. According to a survey, the rate of settlement at this stage is as high as 95%.[7] The major function of pre-trial procedure lies in resolving disputes by collecting and establishing evidence, sorting out issues, and facilitating a settlement. Trial is the procedure where the jury (or a judge) determines the facts, while the judge applies the law and renders final judgment. In the United States, the provisions setting a time limit for presenting evidence are embodied in the pre-trial procedural rules, which include discovery and pre-trial hearings/conferences. These two procedures may alternate (e.g., discovery, hearing on motions, additional discovery, etc.).[8]

The discovery phase, the most distinctive procedure in U.S. civil litigation, differentiates it from pre-trial procedure in other countries. During discovery, each party provides the opposite side

[7] QI SHUJIE, AMERICAN CIVIL JUDICIAL SYSTEM 204 (2011).
[8] LUO YUZHEN & GAO WEI, CIVIL PROOF SYSTEM AND THEORY 457 (2002).

with relevant facts, documents, and other related materials.[9] In accordance with the Federal Rules of Civil Procedure (and state rules), except for exempted information (e.g., attorney-client privileged communications, trade secrets, etc.), the parties are obliged to produce and disclose materials to each other when relevant to claims or defenses. Thus, it can be seen, in U.S. civil litigation, that disclosure of evidence has become an obligation of the parties. Moreover, the scope of evidence disclosed is quite extensive.

Discovery came into being in the era of British Equity Law, and it was eventually established formally by the Federal Rules of Civil Procedure in the United States. Before discovery, one party had to use the evidence she obtained on her own to prove claimed facts, and she was not entitled to require the other party to provide or show her evidence prior to trial. This approach allowed 'trial by ambush,' which contributed wrong decisions by the judge and jury because the parties cannot be fully prepared.

A pre-trial conference is a meeting called by the judge to organize case preparation, hear motions, set out a timeline for trial, and encourage settlement. The pre-trial conference has no rigorous requirements on sequence and may occur at different and multiple times during a case. More often than not, once litigation has started, the judge would take the initiative to call a meeting to make the preliminary arrangements for trial. This kind of meeting generally includes limiting the time (1) to join other parties and to amend the pleadings, (2) to file motions, and (3) to complete discovery. It also often addresses the extent of permitted discovery and may consider any other matter appropriate in the circumstances.

According to the relevant provisions of the Federal Rules of Civil Procedure Rules, the main contents of the pre-trial conference involve: (1) determining the date to exchange evidence, (2) orders for evidence exchange, (3) the form and content of the pre-trial orders, and (3) the determination of a reasonable time for evidence production and other pretrial matters. The judge would make relevant court orders and, along with the parties, create an evidence list at the final pre-trial conference. In court, the parties are not permitted to present new evidence or evidence which is excluded from the evidence list. The judge can refuse to consider the evidence or restrict the parties' proof. The modification of this

[9] QIAO XIN, FOREIGN CIVIL PROCEDURAL LAW 102 (2008).

evidentiary list is very strict, and, except for preventing obvious injustice, it will not be modified. Under normal circumstances, several elements should be taken into consideration when the judge makes such orders: (1) whether the opposite party was subject to the loss of a reliance interest,[10] (2) whether the situation has significantly changed since the evidence list was finalized, (3) whether the party did not timely comply with pre-trial requirements, etc.[11] Consequently, we can find that the loss of evidence occurs when the party can be blamed for the delay in presenting evidence, and the exclusion of the evidence will not damage substantive justice.

B. Germany

Enacted January 30, 1877, the German Code of Civil Procedure has a history of 140 years and has experienced over one-hundred amendments. These amendments were to adapt to social development, to pursue equity and justice, and to reflect the Germans' rigorous attitude toward the rule of law.[12] With the code having gone through so many modifications, judges have gradually obtained control over the trial of cases and lawsuit efficiency has become the goal of amendments.

The Stuttgart Model, which is the most far-reaching in Germany, is a model of reform. Previously, the courts permitted the parties to submit evidence at any time during the court hearing stage. Inevitably, this would result in civil proceedings that are complicated and time-consuming, and delayed cases. Following the example of high-efficiency trials in criminal cases, the German Code of Civil Procedure amended more than 150 clauses of civil litigation procedure. This reform abandoned former methods, fixed the date when evidence should be put forward, and increased the pre-trial procedures.

Two points of the German pre-trial procedure are worth noting: the advance first hearing[13] and preliminary proceedings

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[10] 'Reliance interest' refers to the cost the parties paid to prepare for the possible court session based on trusting the court and law.

[11] MARY KEN KANE, CIVIL PROCEDURE LAW 156 (2001).

[12] DING QIMING, THE GERMAN CODE OF CIVIL PROCEDURE 1 (2016).

[13] The German Code of Civil Procedure Article 275 provides the following:

> By way of preparing for the advance first hearing, the presiding judge, or a member of the court hearing the case delegated by the presiding judge, may set a deadline for the defendant by which he is

conducted in writing.[14] The courts control the process of the two procedures and determine the period for the defendant's response. The German Code of Civil Procedure, Article 282, provides: In the hearing, each party is to submit to the court allegations, denials, objections, defense pleas, evidence, and objections to evidence submitted. These are to be submitted as promptly as possible, based on the circumstances of the proceedings. This corresponds to and promotes a diligent pursuit of court proceedings. When it is foreseeable that the opponent will be otherwise unable to react to

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to submit a written statement of defense. Alternatively, the defendant is to be instructed to have the attorney submit to the court, in a written pleading and, without undue delay, any means of defense that are to be brought before the court; section 277 (1), second sentence, shall apply mutatis mutandis. (2) Should the proceedings not be conclusively dealt with and terminated at the advance first hearing, the court shall issue all orders still required to prepare the main hearing for oral argument. (3) At the advance first hearing, the court shall set a deadline for submitting a written statement of defense should the defendant not yet have responded to the complaint at all, or not sufficiently, and wherever no deadline pursuant to subsection (1), first sentence, has been set. (4) At the advance first hearing, or upon having received the statement of defense, the court may set a deadline for the plaintiff within which he is to state his position in writing as regards the statement of defense. The presiding judge may set such deadline also outside of the hearing.

[14] The German Code of Civil Procedure Article 276 prescribes the following: (1) Should the presiding judge not arrange a date for the advance first hearing for oral argument, he shall instruct the defendant, in serving the complaint upon him, that should the defendant wish to defend against the complaint, he should notify the court of this fact within a statutory period of two weeks after the statement of claim has been served on him; the plaintiff is to be informed of these instructions having been issued. Concurrently, a deadline is to be set for the defendant within which he is to submit his written statement of defense, which period shall be at least a further two weeks. For any service of the complaint to a recipient abroad, the presiding judge is to set the deadline in accordance with the first sentence. (2) Concurrently with these instructions, the defendant is to be instructed of the consequences should he fail to meet the deadline imposed on him pursuant to subsection (1), first sentence, and also as regards the fact that he may only declare his intention to oppose the complaint via an attorney he is to appoint. The instructions given as to the option of a default judgment being entered pursuant to section 331(3) shall also address the legal consequences set out in Sections 91 and 708, Number 2. (3) The presiding judge may set a deadline for the plaintiff within which he is to state his position in writing as regards the statement of defense.

petitions, and challenges to or defenses against the petitions, without previously making inquiries, they are to be communicated prior to the hearing by a written pleading in a time that still enables the opponent to make the necessary inquiries. Concurrently, the defendant is to file any objections concerning the admissibility of the complaint prior to being heard on the merits of the case. Should, prior to the hearing, a deadline be set for the defendant to submit his statement of defense, he is to raise his objections within this period.

Should a party not be able to make a statement regarding the opponent's submission to the court because this was not communicated to the party in due time prior to the hearing, the court may determine, upon the party's application, a time limit within which the party may submit her statement in a written pleading. Concurrently, a hearing shall be arranged at which the decision is announced. The court must take into account any declaration submitted within the allowed time limit and may take into account any statement submitted late.

We can see that the code requires the parties to put forward, in due time, the challenges and defenses. However, the court has no specific right to, independently, determine this procedure. Instead, the code only prescribes that the parties can propose the methods of presenting challenges and defenses, and abide by the legal procedures.

Additionally, the German Code of Civil Procedure further provides the consequences of being past due in submitting the means of challenge or defense. Any means submitted after the deadline are admitted at the court's discretion only if admitting them would not delay the process and resolution of the legal dispute, or if the party provides sufficient excuse for the delay. The court may refuse to admit the means if they are not submitted or communicated in due time, or if the court finds that admitting them to the proceedings would delay the process, and the delay is the result of gross negligence. Any late objections concerning the admissibility of the complaint that the defendant elected to forgo are to be admitted only if the defendant provides sufficient excuse for the delay.

In theory, the obligation of promoting proceedings in Germany can be divided into two types. The first is the general obligation, which primarily involves the court contest between the parties. In this proceeding, the parties shall comply with the general rules of procedural law and put forward or state the means

of challenge and defense. When the opponent cannot reply because she does not know enough about the case, the other party shall make written materials and fulfill the duty of notification in a timely manner, thus ensuring that the opposing party obtains a necessary understanding of the case. The second type is the specific obligation, which refers to the court's determination of the period for pleading and second pleading. Both sides shall strictly comply with the deadline and determine the means of challenge and defense in accordance with the legal procedure.[15]

To present evidence in time is part of the general obligation of promoting proceedings. With regard to evidence submitted after the deadline, the court has veto power over its admission. The court can make these decisions within its discretion, but it should take related factors into consideration. When determining whether the proof should be admitted, the courts should take into account whether admission will affect the normal proceedings and whether the party was at fault.

C. France

Similar to the German Code of Civil Procedure, the Civil Procedure Law of France has experienced a long modification process and the period of evidence presentation has changed from presenting at any time to presenting in due time. France's pre-trial procedures fully reflect the organic combination of the parties' right of disposition and the judge's power over case management. It aims to fit the case to the preparation activities of the parties and courts, and to make clear the claims and evidence of both sides.[16] Thus, the primary purpose of French pre-trial procedure is to fix the issues and evidence.

In the course of civil proceedings, the attorneys, as party advocates, are entitled to participate in the pretrial procedure. In the light of France's Civil Procedure Law, one party shall provide his evidence and facts, and submit correlative written materials. During the pretrial procedure, the parties obtain information about the case by exchanging the complaint and pleading-in-answer, and submitting associated written materials. Of course, if a party fails to put forward this evidence in pretrial procedure, then the parties

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[15] CHANG YI, COMPARATIVE STUDY OF THE CIVIL PROCEDURE LAW 539 (2002).

[16] ZHANG WEIPING & CHEN GANG, AN INTRODUCTION TO THE CIVIL PROCEDURE LAW OF FRANCE 187 (1997).

will not be allowed to submit it in the subsequent procedures of the court trial.[17]

From these details, the pretrial procedure in France aims to mutually share knowledge of the case before trial, so that the parties can more equally prepare their respective cases. During pretrial procedure, the judge plays the leading role and has the right to decide when to terminate the procedure, and the parties conduct activities under the control of the judge. The judge should decide if she wants to end the procedure.

Article 135 of the Civil Procedure Law provides that, after a ruling to end the pre-trial procedure, the parties shall not submit relevant documents, including preparation letters and written pledges. If the parties violate the rules, the court can refuse to accept the case. Once the ruling is made, it indicates that the case has come to the appropriate phase where trial can be started, and the court can then appoint a beginning date. This process' purpose is to supervise and urge both parties to take the initiative to participate in the procedure and prepare for the beginning of trial. If the parties fail to follow this procedure, by trying to present past-due evidence or delay without acceptable reason, they will bear adverse legal consequences.

On the whole, France's procedural law setting a time limit for presenting evidence is not very rigorous. The parties can present evidence in the pretrial procedures, but they are not permitted to produce evidence after the judge has ended these procedures. Parties lose the right to present evidence when they did not timely exchange claims and evidence. In order to ensure that documentary evidence is timely put forward and acquired,[18] the judge has significant power over pretrial procedure. The judge can make determinations or take measures based on this authority.

D. Japan

The Japanese Civil Procedure Law was enacted in 1890 and

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[17] CHANG YI, NEW DEVELOPMENTS OF FOREIGN CIVIL PROCEDURE LAW 145 (2009).

[18] For example, Article 138 of the Civil Procedure Law of France prescribes that, in the course of a lawsuit, when one party intends to quote the notarial certificate or private certificate, when he is not the possessor, or intends to use the documents or written evidence held by the third party, he can file his plea to the judge, who then commands the party to submit the documents and written evidence or transcripts of them.

went into effect on January 1, 1891. As a result of the influence of German law, Japanese Civil Procedure Law, from the beginning, had a strong feature of German law. Because there were many drawbacks in the old law, such as a long trial time and high cost, the Japanese legislature formally adopted the new Civil Procedure Law on June 26, 1996. Before the amendment, Japanese civil procedure did not provide for advanced preparatory procedure, and the judge lacked the jurisdiction over such a procedure. At the same time, in order to prevent evidence disqualification, the parties tended to overproduce all kinds of evidence. This situation expanded the dispute's scope and reduced trial efficiency.

To apply the best procedure to determine the points in dispute and clarify evidence between the parties as soon as possible, the amended Japanese law divided the oral argument into the preparation stage for the oral argument and the trial stage focusing on the dispute. Its objective is to make sure that, in the early stage, the dispute is clear, and then the substantive trial begins. So the efficiency of the trial is improved and trial functions perfected.[19] Simultaneously, due to the revised Civil Procedure Law, the random pre-trial presentation of proof was changed into a limited-time doctrine, and three procedures were developed for sorting: Preliminary Oral Arguments,[20] Preparatory Proceedings,[21] and Preparatory Proceedings by Means of Documents.[22]

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[19] TANG WEIJIAN, STUDY ON FOREIGN CIVIL PROCEDURE LAW 91 (2007).

[20] A 'prepared oral argument' is a process of oral argument to conclude the disputes and sort out evidence. For a case with a large social impact, a public trial is more appropriate. No matter the preparation of the trial or the substantial trial process, deciding the day of trial is in the authority of the chief judge. So, the chief judge decides when the prepared oral argument procedure starts, without the suggestion of the parties. Preparation is proceeding during the public trial; except during questioning of the witness, the parties can debate, review documentary evidence, exchange proof, etc.

[21] 'Preparatory proceedings' are not in the form of a public trial but in the case of non-disclosure. They are for the judge and the parties to carry out a centralized trial to conclude the disputes. The most general preparation procedure in Japan is established by combining the pre-trial meeting, found in the United States, and the legal principle of litigation in the civil law countries. The difference between this procedure and the prepared oral argument is mainly that the court adopts a non-public way for preparation for oral argument. This is related to the basic rights of citizens for an open trial. Therefore, the court began to listen to the opinions of the parties. Even during the proceeding; if the both parties oppose it, the court has to withdraw the procedure.

[22] In the preparatory proceedings handled through documents, the parties do not need to appear in court. The court will ask the parties to provide documents, and with the help of the telephone conference, the proceedings are completed.

According to the Civil Procedure Law, allegations and evidence will be advanced at an appropriate time depending on progress of the suit. Regarding allegations or evidence that a party has advanced outside the appropriate time, intentionally or by gross negligence, the court may order dismissal upon a party's petition or its own authority, when the court finds that such allegations or evidence will delay the conclusion of the suit. After completing the procedures for evidence and issue presentation, the court and parties determine the validity of the evidence and the facts during trial stage. At the end of the pre-trial procedure, the parties can still put forward offensive or defensive evidence, but only with acceptable reasons.

Similar to the French law, Japan's Civil Procedure Law is not very strict regarding losing the right to present proof. The parties may present new evidence after the time limit if they satisfy the following conditions. Firstly, the party should provide a reasonable basis for the late submission when the other party requests a reason. Secondly, the judge should conclude that the party providing evidence exceeded the time limit not to delay the proceedings. If the late production of evidence is not on purpose or due to gross negligence, the judge, in her discretion, can allow the evidence in the oral argument stage even if the proceeding may be delayed.

In order to improve the procedure of sorting out arguments, and ensure that the deadlines for submitting evidence have legitimacy, the Japanese law improves the system of evidence collection. This reform mainly includes the following aspects. First, there is a document order system. This system has been used in common law and civil law countries. In U.S. adversarial civil proceedings, when the party collects evidence from the other party, the court, in principle, should not intervene. In civil law countries, such as Germany and Japan, the parties collecting evidence or

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When the parties live far away, or in other situations the court considers appropriate based on the parties' arguments, the court could make a decision on the application of preparatory proceedings by means of documents. It is not simply an exchange of preparatory documents but a separate trial procedure to conclude the disputes. This procedure is initiated by the court; and, at the end of the proceeding, as with the prepared oral argument, the court can ask the parties to make a summary document of the disputes and evidence in the case. Moreover, during the oral argument, after the end of this preparatory proceeding, the court should confirm to the parties the facts that should be proved, and the court clerk should memorialize in the oral debate record the confirmed facts.

proving the facts should follow the court's direction. This means that collecting evidence from the other party or third party should first apply to the court. The document order is based on the request of a party, which is then issued by the court to the other party or a third party who holds the requested document.[23] Therefore, the document order system is a means for the party to receive documentary evidence from the other party or a third party, through the court.[24]

Secondly, the Japanese Civil Procedure Law establishes an interrogation system based on the pre-trial discovery process in the U.S. Federal Rules of Civil Procedure. The parties do not collect evidence from each other, directly, but collect relevant information held by the other party in order to allow the requesting party

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[23] Article 220 of Japanese Civil Procedure Law provides that, in the following cases, the holder of the document may not refuse to submit the document:

(i) Where a party personally possesses the document that he/she has cited in the suit.

(ii) Where the party who offers evidence may make a request to the holder of the document for the delivery or inspection of the document.

(iii) Where the document has been prepared in the interest of the party who offers evidence or with regard to the legal relationships between the party who offers evidence and the holder of the document.

(iv) In addition to the cases listed in the preceding three items, in cases where the document does not fall under any of the following categories:

(a) A document stating the matters prescribed in Article 196 with regard to the holder of the document or a person who has any of the relationships listed in the items of the article with the holder of the document.

(b) A document concerning a secret in relation to a public officer's duties, which, if submitted, is likely to harm the public interest or substantially hinder the performance of his/her public duties.

(c) A document stating the fact prescribed in Article 197(1)(ii) or the matter prescribed in Article 197(1)(iii), neither of which is released from the duty of secrecy.

(d) A document prepared exclusively for use by the holder thereof (excluding a document held by the State or a local public entity, which is used by a public officer for an organizational purpose).

(e) A document concerning a suit pertaining to a criminal case or a record of a juvenile case, or a document seized in these cases.

[24] BAI LVXUAN, NEW JAPANESE CIVIL PROCEDURE LAW 15 (2000).

pursue evidence collection. A party can request information, including the names, address and telephone numbers of the opposing party or the third party who holds the documents. Based on this system, the party can apply to the court for witnesses or document orders.[25] Therefore, the Japanese system does not affect the basic principles of the combined adversary and authority systems because the requesting party has to apply to the court to collect evidence, as in civil law countries.

Thirdly, the inspection method for digital evidence, such as audio or video tape, is clearly defined as part of the documentary evidence review. The prior civil procedure law did not clearly stipulate the inspection methods for the audio, video tape, and computer disk as evidence. This also impacted the methods that the parties can use to collect evidence. Article 231 in the new Civil Procedure Law of Japan stipulates that the methods for inspecting documentary evidence should apply to digital evidence. Thus, if a party wants to collect the digital information, which is held by the opposing party or a third party, the party could seek a document order from the court, unless the opposing party does not object to the production.

E. Comments on the Time Limit for Adducing Evidence in Foreign Countries

By making a general study of the legislation of all the major countries, the time limit for presenting evidence has changed a random process to one setting time limits. Although the civil procedure law of different countries stipulates similar provisions

[25] Article 163 of Japanese Civil Procedure Law provides that a party, while the suit is pending, may specify a reasonable period and make an inquiry, by means of a document, to the opponent in order to request that the opponent make a response, by means of a document, with regard to the matters necessary for preparing allegations or proof, provided, however, that this shall not apply where the inquiry falls under any of the following items:

(i) Inquiry that is not specific or individual.
(ii) Inquiry that insults or confuses the opponent.
(iii) Inquiry that overlaps with any previous inquiry.
(iv) Inquiry to ask opinions.
(v) Inquiry for which the opponent is required to spend unreasonable expenses or time to make a response.
(vi) Inquiry on the matters that are the same as the matters about which a witness may refuse to testify pursuant to the provisions of Article 196 or Article 197.

about past-due evidence, there remain many differences. Key points in this comparison are set out below.

Firstly, the setting of pre-trial procedures differs. The objective of the pre-trial procedure is to resolve procedural the disputes and collect evidence, so that the case can enter the trial, successfully. According to U.S. federal procedural law, the judge manages the pre-trial procedure to resolve these disputes and fix evidence. After the final meeting, the case is ready for trial, and needed evidence is allowed. Germany, France, and Japan also set the pre-trial procedure. During this period, the parties need to put forward their claims and evidence in a reasonable period of time, and they cannot put forward evidence randomly during the trial, except as otherwise stipulated by law. Thus, those countries combine pre-trial procedure with a time limit on presenting evidence to ensure the successful preparation before the trial.

Secondly, the laws cover the rights of the parties to investigate and obtain evidence. Each country has different provisions about the right to collect evidence to protect the legitimacy of their deadlines. According to provisions in U.S. civil procedure law, the parties can get to know the facts through the discovery procedure or by collecting evidence independently. The evidence collected by the parties should be disclosed in accordance with the discovery rules. Although they do not have the developed evidence discovery system found in the United States, the substantive and procedural laws of Germany, France, and Japan provide sufficient investigation rights for the parties.

Thirdly, exceptions to losing the right submit late evidence. Parties support their claim by providing evidence. Consequently, all countries preserve a cautious attitude on evidence submission, so their laws stipulate the time limit and scope of penalties for late submission. Otherwise, trials become unfair.

In Germany, whether the past-due evidence could be accepted depends on factors such as whether the party has subjective fault or allowing the evidence would delay litigation. In Japan, the parties need to make a statement and provide a reasonable explanation for the past-due evidence, unless accepting the evidence would not affect the normal proceedings, in which case the judge can admit the evidence.

V. PROBLEMS WITH THE TIME LIMIT FOR PRESENTING EVIDENCE IN CHINA

The evolution of the time period for producing evidence in China results from incessant negotiations and reconciliations over fairness and efficiency, and over entity justice and procedural justice in civil cases. The result has reached a superior balance between effectiveness and substantive justice. However, the time limit for adducing evidence still faces a real dilemma, notwithstanding all its advantages.

A. The Determination of the Deadline for Proof Through Negotiations of Parties is in Name Only

In practice, negotiation between parties over terms for producing evidence rarely happens; rather, the court designates the time.[26] There are several reasons for this. Firstly, for the plaintiff, he will be served notice of case filing and for presenting evidence when his case is docketed by a court. The judge of the case generally decides a time for presenting evidence in a summary procedure or formal procedure, or in accordance with the court's usual practice. Therefore, after the case is transferred to each business division of the court, the judge handling the case can only serve the defendant the notice of presenting evidence in accordance with the notice that has been earlier served on the plaintiff. Secondly, some parties would not favor a negotiation with the other party given the opposition between them. Thirdly, it is also not practical for the judge to accept a time agreed to by the parties since more knowledge about the complicated details of the case is needed.

B. Pretrial Procedures are not Complete

The existing pretrial procedures in China are not as functional as they are supposed to be. Instead, it has degraded into a legal process of merely serving the parties with notice of participating in the action. In addition, the exchange of evidence does not function widely and no more than as a form. The main problems are the following. Firstly, the exchange of evidence is applied in a relatively narrow scope and not compulsory. In accordance with

[26] Xia Xianhua, *The Practical Problems and Solutions of the Time Limit System of Evidence in China*, 6 Journal of the Postgraduate of Zhongnan University of Economics and Law 138 (2015).

the Evidence Provisions, the court shall arrange the two parties concerned to exchange evidence where there is a significant amount of evidence or there are cases which are difficult in nature. As for other civil lawsuits, evidence exchange shall be upon the application of the parties, and the court "may" arrange for an exchange prior to holding a court hearing, which is not compulsory. In judicial practice, almost all the cases heard under summary procedure have not gone through the exchange of evidence, and the number of such cases has accounted for about 80% of all civil cases. Thus, the vast majority of civil cases are handled without the exchange of evidence.

Secondly, the legal norms of the evidence exchange system are rather rough. The Civil Procedure Law (2012 Amendment) has only prescribed that the court shall "clarify the focus of disputes by requiring the parties to exchange evidence and other means, if it is necessary, to hold a court session." Article 224 of the Civil Procedure Interpretation similarly prescribes only that "the court may, after the expiration of the time period for a reply, prepare the pre-trial procedure by arranging the exchange of evidence, convening a pre-session meeting, etc.," without further prescription of practical and specified operational norms. Thirdly, there are mistaken understandings and behaviors in practice. Actually, evidence exchange is often scheduled on the same day with the trial, with the parties arranged to exchange evidence, produce evidence, and cross-examine just before the trial. Therefore, matters to be conducted in the court investigation during the trial have been conducted before the trial, resulting in a situation where the exchange of evidence is no more than a form. Apart from that, some judges deem the daily delivery of evidence as the exchange of evidence, which is a misunderstanding of the essence of the system.

C. Cost Sanction is Ineffective

The cost sanction has eased the sharp contradiction between strict evidence disqualification and substantial justice, combined the two rudimentary demands of finding the truth and accelerating the lawsuit process, and satisfied the legal practice in China. However, the implementation of the cost sanction still faces difficulties and obstacles. Firstly, this measure is rather disfavored and deliberately avoided by many judges because its employment will undoubtedly place a greater burden on them to get approval

from the president of the court in advance. Secondly, the Civil Procedure Law has prescribed that the amount of fine imposed on individuals is RMB 100,000 yuan or less, and the amount of fine imposed on units is RMB 50,000 yuan to RMB 1,000,000 yuan. This substantial difference in the standard of the penalty results in excessive judicial discretion. It is also unreasonable that the amount imposed on the party who has provided evidence beyond the time limit is larger than the value of losing the case or losing damages if the evidence is not accepted. Thirdly, it is not only a waste of legal resources but a direct damage to the procedural interest of the other party if the evidence is provided late and the trial is delayed. The Civil Procedure Interpretation prescribes "where a party requests the opposite party to compensate for costs of transportation, accommodation, meals, lost labor, witness presenting at court, and other necessary expenses arising from past-due provision of evidence, a people's court may be supportive." However, it is still unclear how to proceed with this compensation. In a word, fines do not play a good role in legal practice.

D. Judicial Environment is not Friendly

At present, the legal situation is generally not so promising to accomplish the goal of producing evidence in a limited time period. If the time period for producing evidence is rigorously carried out, many incorrect fact-findings, judgments, and rulings would occur, and, consequently, the proportion of substantially unjust verdicts will result. This will shake people's trust in the impartiality and fairness of law and justice. Meanwhile, it does not provide social benefits to accept disqualified evidence and reach a verdict, which then causes the losing party to file an appeal or seek a retrial.[27] In addition, with the negative attitude toward the rates of appeal, remand, second correction, review, etc. particularly with the recent evaluation mechanism of courts and judges, the reluctance to disqualify evidence is furthered. The disfavor of evidence disqualification is an inevitable outcome of China's legal environment.

[27] Xia Xuan, *The Operation Puzzledom and Reform Route of Evidence Disqualification of the Right*, 10 Hebei Law Science 156 (2015).

VI. IMPROVING THE TIME LIMIT FOR PRODUCING EVIDENCE OF CHINA

Notwithstanding the superiority of the current system, the applicable laws are not complete. This paper argues that the following aspects of China's time period for evidence exchange should be revised.

A. Clarifying Determination of the Time Limit for Evidence Production

Since the parties' negotiation over evidence production was more formalistic than practical, this process should be better defined for the parties. This may make the process more agreeable, decreasing the parties' mental repulsion towards it and constraining the court from arbitrarily deciding evidence production. The superiority of the parties' determination should be recognized, while it can be changed by the court in case of an unreasonable outcome or failed negotiation. Operationally, appropriate ways of negotiating should be created to meet actual necessities. For instance, the rules could require that an explanation of evidence production and a recommendation for negotiation be enclosed with the notice for producing evidence that is served on the plaintiff and defendant, or that the parties be contacted through telephone, video conference, etc., to negotiate.

B. Perfecting Pretrial Procedures

It is critical to perfect the pretrial procedure, with a core evidence exchange, for parties to comply with their obligation of timely producing evidence. To this, the paper suggests the following measures. Firstly, the legal system should require the exchange of evidence in general civil cases in principle, except for the small claims procedures. This move on the surface increases the burden on the court, but better specification of the evidence exchange system can help the parties reach a settlement or other conciliation on the basic understanding of facts and proofs in a case. This should also avoid repeated trials. Secondly, the system should establish detailed rules and regulations of evidence exchange by clarifying the time for pretrial exchange of evidence and stating the measure of exchange, the organization of the

exchange, and the sanction for parties not attending. Thirdly, the system should create diversified means of evidence exchange to satisfy the different, actual needs of the judiciary, such as written forms of evidence or evidence exchange over the telephone or by video conference. For simple cases heard under a summary procedure, it is appropriate to choose convenient and efficient ways for exchange.

C. Clarifying the Penalty Standard and Procedure of Compensation

Firstly, the specific amount of the fine can be decided by a judicial organization after comprehensive consideration of the particular circumstances of the case, the probative force of past-due proof, and the degree of subjective fault of the parties. At the same time, in case the target amount of the fine is in different ranges, a corresponding floating range should be established to match the illegal costs of different cases and, to a certain extent, limit the discretion of judges.

Secondly, the parties, who have not timely produced evidence, may object to the court's cost sanction and choose, instead, evidence disqualification. Professor Qiu Liangong pointed out that "Legislators and judges should, when employing a procedure concerning the procedure-related person in aspects like his interests, position, obligations and rights, endow him with a comparable right of participation and right to choose the procedure to achieve and secure his substantive interests and procedural interests."[28] Hence, it will not be unreasonable to give the parties the right to make an objection and choose the type of sanctions, provided the parties at fault believe that the material disqualification they bear from the court's fine is greater than the one brought by evidence disqualification.

Lastly, the system should set a definite cost compensation procedure. Where a party requests that the opposite party compensate her for the costs of transportation, accommodation, meals, lost labor, witness presentation at court, and other necessary expenses arising from the past-due provision of evidence, a people's court may be supportive. As long as a party has adduced past-due evidence, whether his reasons are legitimate or not, he is likely to suffer a sanction imposed by the private law,

[28] QIU LIANGONG, ON THE OPTION OF CIVIL PROCEDURES 33 (2000).

where the adverse consequences must be based on the request of the other party.[29]

Here, two things need to be clarified. Firstly, how do we understand the nature of "necessary expenses." Article 39 of the Interpretation of the Supreme People's Court on Several Issues Concerning the Application of the Trial Supervision Procedure under the Civil Procedure Law in 2008 (the Supervision Interpretation) stipulates that:

> [W]here the respondent and other parties request that the petitioner, or the party applying for a protest, compensate for the increased costs of transportation, accommodation, meals, lost labor, and other litigation expenses, arising from their fault in presenting new evidence, and causing the failure of the respondent and other parties to present proof timely in the original procedures, the court shall be supportive.

The phrase in the Supervision Interpretation is to "make up for" the litigation expenses, while in Article 102 of the Civil Procedure Interpretation it is to "compensate" for the necessary expenses. If "necessary expenses" is defined as "litigation expenses," then, once the opposing party in this case requests the responsible party to bear the cost of litigation, the judge shall resolve it in the same lawsuit. Since it is a cost of litigation, the parties cannot appeal for this cost alone after the court decides. It is self-evident that costs of transportation, accommodation, meals, lost labor, presenting witnesses, appraisers, translators, and adjusters belong to litigation expenses. But whether the cost of transportation, accommodation, meals, lost labor, and presenting parties and agents are included in litigation expenses is controversial.

If the costs of transportation, accommodation, meals, lost labor, presenting the parties and agents are defined as litigation expenses, the judge shall resolve them in the same lawsuit. Otherwise, it should be included in the direct loss and be resolved in the other lawsuit. As for which choice is better, it will take judicial interpretation to clarify further the implementation of the

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[29] Long Xingsheng & Wang Cong, *Consilience and Transcendence: Cautious Application of Evidence Disqualification in Chinese Civil Procedure*, 1 Evidence Science 77 (2016).

law. How to understand the expanded "direct disqualification" caused by compensating the opposing party for past-due proof is another question. The 2012 Amendment of Civil Procedure Law and its interpretation did not provide an answer for this, but Article 39 of the Supervision Interpretation has stipulated that the other party's request for compensation is expanded and direct disqualification may be filed separately. This kind of dispute belongs to damages for infringement in nature, an infringement due to the past-due provision of evidence, and would be resolved in another case based on the request of the parties. However, defining the scope of direct disqualification needs continual exploration in judicial practice.

D. Strengthening the Interpretation Obligation of Judges

The interpretation obligation means that judges in civil litigation shall, by questioning the parties about the facts and legal problems of a case, urge the parties to make further statements or complement lawsuit materials and proofs of the case, for the purpose of clearer litigious relations and learning the truth. Thus, it can be seen that the contents of interpretation include not only inquiring about and urging the parties to state their respective factual claims, but also urging the parties to adduce evidence. Although the use of interpretation is prone to abuse and breaking the balance of power between the parties, it is still appropriate and necessary to strengthen judges' interpretation obligation in the law's evidence-producing sections. If the judge does not interpret, it would be demanding for ordinary people to understand and accept the concept of a time period for producing evidence and evidence disqualification, especially considering that a compulsory lawyer agency system in civil lawsuits has not been built up China and there often is sharp disparity in legal knowledge and legal consciousness between parties. This will not only result in the emergence of unfair lawsuits and incorrect judgments, but the defeated party will be more likely to appeal.

VII. CONCLUSION

The time limit for presenting evidence is an important part of the modern civil litigation system. The introduction and

establishment of the time limit for presenting evidence in China is also an inevitable requirement of the development trend of the world civil procedure system. Therefore, the time limit for presenting evidence cannot be easily abandoned due to the existence of problems. The time limit for presenting evidence is an important link in the establishment of a party-litigation model in China, so the time limit for presenting evidence must be continuously perfected. Taking China's existing national conditions into account, the improvement and reform of the time limit for presenting evidence cannot be treated as isolated events and must be combined with other related civil litigation system to be considered. Only in this way, can we really improve the effectiveness of the time limit for presenting evidence.

Keywords
Chinese Civil Litigation, the time limit for adducing evidence, evidence disqualification, pre-trial procedure, the interpretation of judges

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THE LAW AND POLITICS OF ISLAMIC FINANCE IN A NON-ISLAMIC STATE: *SUKUK* IN THE KOREAN CAPITAL MARKETS

Mee-Hyon Lee[*]

ABSTRACT

In 2008, Korean Government prepared a tax bill to achieve a level playing field in the tax treatment of sukuk and conventional foreign currency bonds. The bill attracted heated political debate and was criticized as giving favorable tax treatment to 'Islamic bonds.' Despite repeated submissions to the National Assembly in two consecutive sessions, the bill was rejected and Korean Government's efforts at fostering an amicable environment for the issuance of sukuk came to an abrupt halt.

Among the tax burdens related to sukuk, the most critical one is the withholding tax imposed on profits of sukuk, which arises from the fact that the tax exemption granted in connection with profits of conventional bonds are not equally available to profits of sukuk. Thus, if the scope of tax relief is limited to merely extending such exemption to sukuk profits, it can be justified as seeking equal tax treatments for all securities with economic substance similar to conventional bonds. So, it is likely that such a tax bill would pass the National Assembly without much debate or difficulty. With this tax relief in place, sukuk issuance would become a real financing option. Hence, it would be reasonable to propose bifurcating the future tax reform efforts into a tax relief on profits and a tax relief on transaction-related taxes, and focus only on the former for the time being.

I. INTRODUCTION

Diversifying funding sources has been a long desire of Korean companies and financial institutions. In light of the remarkable growth of Islamic finance and its ever increasing relevance in the global finance market,[1] market participants in

[*] Professor, Yonsei Law School.

[1] The growth of the Islamic capital markets just before the Global Financial Crisis (i.e. from 2004 to 2007) was one of the most significant developments in the global capital markets. At its peak in 2007, the total global *sukuk* issuance

South Korea (Korea) have been keenly interested in attaining more direct participation in the Islamic financial market.[2] Specifically, *sukuk*[3] issuance is regarded by Korean companies as a means to gain access to a new pool of investors whose credits would not otherwise be available to them.[4] In addition to diversification benefits, *sukuk* issuance allows the issuers to align their investor base with their strategic business interests in the region.

Despite economic similarities to conventional bonds, *sukuk* are structured in a different way to ensure religious compliance. This structural nature sits awkwardly with the Korean legal and tax framework, which is primarily governed by the conventional finance system, causing certain legal and tax hurdles for issuance of *sukuk* by Korean companies. To facilitate Korean companies to tap the Islamic finance market effectively, there have been calls that Korean laws be synchronised and not unduly hinder or restrict the orderly development of *sukuk.*

With the outbreak of a global financial crisis in 2007, Korean companies suffered from serious funding difficulties. Confronted with a heavy pressure to diversify funding sources to alleviate such funding difficulties, Korean government pursued an Islamic

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reached US$50 billion. *See* INTERNATIONAL ISLAMIC FINANCE MARKET, *SUKUK* REPORT: A COMPREHENSIVE STUDY OF THE GLOBAL SUKUK MARKET 9 (3rd ed. 2013), http://www.iifm.net/documents/iifm-sukuk-report. *Sukuk* issuances dropped off temporarily during the global financial crisis, however, it appears the financial crisis proved that prohibition of interest shielded investors from the full force of the fallout and this resilience, along with the high demand from Middle Eastern states seeking to park their cash into *sukuk*, has led to a rapid revival of *sukuk* issuances. *See* Shaun Drummond, *Islamic bonds find favour in Australia*, FINANCIAL REVIEW, March 27, 2013, http://www.afr.com/news/policy/foreign-affairs/islamic-bonds-find-favour-in-australia-20130326-j79qg.

[2] Since 2007, a number of Korean financial institutions have made efforts to make inroads to Islamic finance world. For example, Shinhan Securities Co. Ltd. established a strategic alliance with KIBB Securities in Malaysia as of January, 2007; Korea Exchange Bank, Hana Bank and the Export-Import Bank of Korea each opened an office in UAE and established a subsidiary in Indonesia, respectively. *See* Jung Han Han & Sang Soo Park, *The Development Process of Islamic Finance and Korean Initiative,* 5 JOURNAL OF OFFSHORE FINANCIAL SERVICES, December 2012 at 67, 92-93.

[3] The term *'sukuk'* is the plural of '*sakk*' in classic Arabic, meaning bond or certificate.

[4] Considering that both conventional and Islamic investors can invest in *sukuk*, issuing *sukuk* enables the issuer to tap the full spectrum of investors. *See* Yavar Moini, *Comparisons and Differences between Sukuk and Conventional Products*, in SUKUK AND ISLAMIC CAPITAL MARKETS 35, 37-38 (Rahail Ali ed., 2011).

finance reform in 2009-2010 to foster favorable legal and tax environments for issuance of *sukuk* by Korean companies. Regretfully, however, these efforts did not come to fruition due to the heated political debates and controversies in the legislature and elsewhere.

This article will firstly consider the distinguishing features of *sukuk* as compared to conventional bonds and how these differences cause conflicts and obstacles under the Korean legal framework that hinder economically viable issuance of *sukuk*. Thereafter, the failed Islamic finance reform pursued by the Korean government in 2009-2010 will be canvassed to analyze the reasons for the failure. Finally, the paper will suggest an alternative route for a successful Islamic finance reform in the future. For the sake of simplicity, discussions in this article will center on the legal issues related to Korean companies established in the form of a corporation (*chusik hoesa* in Korean*)* because they constitute a vast majority of the Korean business entities operating in Korea.

II. DISTINGUISHING FEATURES OF *SUKUK*

A. Islamic law and Jurisprudence

Sharia[5] law is the body of Islamic rules and norms but there is not a strictly codified uniform set of laws that can be called *sharia*. The Islamic legal system is in fact a common law system, built primarily on analogy to precedents.[6] *Sharia* law is a broad term that indicates the whole set of legal rulings derived by jurists over times from the religious precepts of Islam. The two primary sources of *sharia* are the sacred words of the *Qur'an*[7] and the inspired guidance of the Prophet Muhammad, known as the s*unna* (the reported sayings and actions of the Prophet). Until reduced to written reports called the *hadith*, the reports of *sunna* survived for centuries in the form of oral tradition. This allowed for contradictory traditions to exist, and left room for jurists to disagree over means of reconciling them to reach appropriate legal

[5] Sharia means a path to the watering hole in Arabic.

[6] MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 27 (1st paperback ed., 2009).

[7] *Qur'an* is a central religious text of Islam and is believed to be the revelation from *Allah*.

rulings constituting S*haria* law.[8]

Sharia law was developed over times by jurists primarily from four major schools of Sunni jurisprudence[9] and one major school of *Shia* jurisprudence (*Jafari*) working through hypothetical situations based on their interpretations of the foundational texts and, whenever necessary, using the interpretive techniques, most prominently *qiyas*, a form of reasoning largely analogical in nature. Unsurprisingly, in matters that are not covered explicitly in the *Qur'an*, they often disagreed with one another as to the outcome, allowing for a multiplicity of conclusions, which Professor Hamoudi referred to as "structural pluralism."[10]

B. The Birth of Islamic Finance

According to *Sharia*, all financial instruments and transactions must be free from *riba* (unjust enrichment),[11] *gharar* (unnecessary risk or uncertainty),[12] *rishwah* (corruption), *maisyir* (gambling/speculation), and *jahl* (profiting from others' ignorance).[13] The purpose of such prohibition is to achieve fairness through equitable distribution of wealth in the society.[14] Among these, the avoidance of *riba* is the foundational raison d'être of Islamic banking and finance.[15] While Muslims agree that

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[8] EL-GAMAL, *supra* note 6, at 27-28.

[9] They are the *Hanafis*, the *Malikis*, the *Shafi'is* and the *Hanbalis*.

[10] Haider Ala Hamoudi, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*, 56 AM. J. COMP. L. 423, 434-35 (2008).

[11] The term *riba* is derived from the Arabic verb *raba*, meaning to increase.

[12] As almost every commercial contract possesses a level of uncertainty or risk, Islam makes allowance for both risk and/or uncertainty in a contract. The '*gharar* sale', which is prohibited, is any sale in which the *gharar* is the major component. So, *gharar* is of degree; the prohibited type being major or that akin to gambling. Only *gharar* major enough to designate a transaction as a '*gharar* sale' renders the contract void. For details, *see* MAHA-HANAAN BALALA, ISLAMIC FINANCE AND LAW: THEORY AND PRACTICE IN A GLOBALIZED WORLD 35-61 (2011).

[13] OBIYATHULLA ISMATH BACHA & ABBAS MIRAKHOR, ISLAMIC CAPITAL MARKETS: A COMPARATIVE APPROACH, Kindle Location 1938-44 (Kindle Edition, 2013).

[14] Omar Salah, *Islamic Finance: The Impact of the AAOIFI Resolution on Equity-Based Sukuk Structures*, No. 02/2011, TISCO WORKING PAPAERS SERIES ON BANKING, FINANCE AND SERVICES 10 (Tilburg Law School, Mar. 30, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1799222.

[15] BACHA & MIRAKHOR, *supra* note 13, at Kindle Location 1946.

riba is prohibited, there is disagreement over what it is. *Riba* is often translated as 'interest' and this prohibition of *riba* gives rise to the frequently quoted statement, "Islam (or the *Qur'an*) forbids interest." This statement, however, is overly simplistic because *riba* is not exactly the same as 'interest.'[16]

Forbidden *riba* is generally understood as "trading two goods of the same kind in different quantities, where the increase is not a proper compensation," [17] however, the distinction between legitimate compensation and the forbidden *riba* has been a highly controversial issue all along. The *Qur'an* merely prohibited the practice of *riba* without defining it, and numerous jurists have analyzed the juristic meaning of the forbidden *riba* for centuries based on the following statement of Muhammad:

> Gold is to be paid by gold, silver by silver, wheat by wheat, barley by barley, dates by dates and salt by salt, like for like, equal for equal, payment being made on the spot. If the species differ, sell as you wish provided payment is made on the spot.[18]

This statement creates two categories of *riba*: *riba al fadl* (*riba* of excess) and *riba al nasia* (*riba* of delay). On its terms, the statement only applies with respect to six items and to a transaction resulting in delayed receipt on the part of one party. Historically, some schools of jurisprudence refused to extend the application of these restrictions to transactions other than those specified in the statement. On the other hand, the three schools of Sunni jurisprudence that have been historically dominant agreed that the transactions prohibited by Muhammad were only examples of a broader class of prohibited transactions and not a complete enumeration of the restricted transactions.[19] Then, using *qiyas*, they expanded this *riba* ban into a wide array of prohibitions of trade depending on the nature of the items being traded. Even among Sunni jurisprudence, however, the scope of *riba* prohibitions was substantially different, as each school offered a different logic for such expansion.[20]

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[16] BALALA, *supra* note 12, at 62.
[17] EL-GAMAL, *supra* note 6, at 49.
[18] BALALA, *supra* note 12, at 72.
[19] Mohammad H. Fadel, *Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts*, 25 WIS. INT'L L.J. 655, 660-61 (2007-2008).
[20] Hamoudi, *supra* note 10, at 442-43.

Given the structural pluralism in understanding the canonical prohibition of *riba*, it is not surprising that the contemporary interpretation of the prohibited *riba* is still not uniform. Specifically, in terms of financial transactions, there are two modern approaches to the traditional doctrine of *riba*. While a number of scholars take the view that *riba* ban need not encompass 'interest' in contemporary circumstances, [21] the dominant view, as represented by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),[22] and accepted by a significant number of Muslims, equates modern practice of lending at 'interest' with *riba*, thereby prohibiting Muslims from using conventional financial products. This approach led to the birth of Islamic finance, which largely consists of designing instruments that can be deemed to comply with the formal requirements of *Sharia*, while at the same time bearing all the economic attributes of the conventional financial instruments, including bearing 'interest.' Hence, Islamic finance is a prohibition-driven industry. Islamic finance deviates from conventional financial practices insofar as the conventional financial practices are deemed forbidden under *Sharia*.[23]

The dominant view is based on the grounds of economic justice and mutuality. From an Islamic perspective, money and financial assets do not have intrinsic value. They are merely the media of exchange, and not commodities that can be traded.[24] Making profit with money is only permitted when it is invested in a permissible commercial activity that involves the financier or investor taking a real commercial risk.[25] Judge Usmani asserted that it would be "glaring injustice" if a financier were allowed to earn a profit by extending a loan to an enterprise under

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[21] According to them, modern practice of lending at interest may technically qualify as *riba* but it does not constitute the *riba* forbidden in the *Qur'an*, nor is it categorically prohibited by other proscriptions of Islamic law. For additional discussion of this view, *see* Fadel, *supra* note 19, at 680-88; *see also* Hamoudi, *supra* note 10, at 447-49.

[22] AAOIFI is an Islamic international autonomous non-for-profit corporate body which prepares accounting, auditing, governance, ethics, and *Sharia* standards for Islamic financial institutions and the industry.

[23] EL-GAMAL, *supra* note 6, at 8.

[24] BALALA, *supra* note 12, at 26.

[25] Salah, *supra* note 14, at 8-9; *see also* Reimout M. Wibier & Omar Salah, *The Credit Crunch and Islamic Finance: Shari'ah-compliant finance against the backdrop of the credit crisis*, No. 01/2011, TISCO WORKING PAPERS SERIES ON BANKING, FINANCE AND SERVICES 8 (Tilburg Law School, Jan. 18, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1742781.

circumstances where the enterprise fails, and, conversely, it would be unjust to limit a financier to his fixed return where the enterprise earns large profits.[26] Thus, in Islamic finance, transactions should be real-asset based and profit-and-loss sharing should be embodied in such transactions. As profit cannot be guaranteed or predetermined in amount, any return on money whose amount is predetermined is viewed as forbidden *riba*.[27] So, in Islamic finance, the concept of 'interest' is replaced by the concept of profit-and-loss-sharing.[28]

C. Characteristics of Sukuk

Sukuk are often referred to as Islamic bonds equating them with conventional bonds because they are usually structured as fixed-income securities[29] with a commercial nature akin to conventional bonds. However, calling *sukuk* "Islamic bonds" may be a misnomer as they are not IOUs representing debts. While the objective of *sukuk* issuance may be the same as that of a bond, there exist some fundamental differences between these two instruments. *Sukuk* are better described as Islamic investment certificates because non-conventional features of Islamic alternatives or modifications have been added to form the core characteristics of *sukuk*.[30]

Due to these characteristics of Islamic finance, *Sukuk* have certain structural differences that are distinguishable from conventional bonds. According to the *Sharia standard (17)* published by the AAOIFI, "investment *sukuk"* are defined as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership of) assets of particular projects or special investment

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[26] Sharia Appellate Bench, Pakistan Supreme Court, *Opinion Concerning Riba* (J. Usmani section) (Dec. 22, 1999) at ¶¶157-58 (quoted from Hamoudi, *supra* note 10, at 457).

[27] BALALA, *supra* note 12, at 25; BACHA & MIRAKHOR, *supra* note 13, at Kindle Location 1933.

[28] Salah, *supra* note 14, at 8.

[29] This does not mean that fixed-income is guaranteed as there are no fixed coupon payments as in the case of conventional bonds. *Sukuk* are simply structured in such a way to generate a fixed amount of cash flow if underlying assets perform successfully as expected.

[30] Rahail Ali & Imran Mufti, *Legal and Structural Anatomy of a Sukuk*, in *SUKUK* AND ISLAMIC CAPITAL MARKETS 51 (Rahail Ali ed., 2011); BACHA & MIRAKHOR, *supra* note 13, at Kindle Locations 4145-50; BALALA, *supra* note 12, at 30.

activity." This means *sukuk* represent co-ownership rights to the underlying assets and do not represent debt in the conventional sense. While conventional bonds create a claim to cash, *sukuk* represent an asset-based interest.[31]

Thus, the underlying structure of *sukuk* is fundamentally different from that of a conventional bond. Namely, *sukuk* are *Sharia*-complaint certificates whose (fixed) income return derives from ownership (on a *pro rata* and undivided basis) of *Sharia*-compliant assets, including contractual rights, held on trust for *sukuk* holders. No *sukuk* holder can claim a specific part of the assets as its own, as they are co-owned with other *sukuk* holders *pro rata.* Redemption (or principal 'repayment,' to use loose-hand terminology) on maturity or following default is implemented through discharging of an obligation to purchase those assets by a company, bank, or sovereign (commonly called the 'obligor') whose creditworthiness is the economic rationale for investing in *sukuk*.[32] Further, being asset-based securities, *sukuk* are different from actual asset-backed securities in that recourse to the assets underlying *sukuk* should not form the basis for a commercial decision to invest in the *sukuk*, because, typically, only the obligor can and will be obliged to purchase them.[33] The credit rating of *sukuk* largely depends on the creditworthiness of such obligor.

For a typical *sukuk* transaction, a special purpose vehicle (SPV) is established as a separate legal entity from the obligor,[34] and it issues *sukuk* certificates to investors. Using the proceeds from the issuance of *sukuk*, the SPV will enter into a purchase agreement to acquire certain *Sharia*-compliant assets (including contractual rights) from the originator, whose purpose for undertaking the transaction is to raise financing. The SPV will hold the *Sharia*-compliant assets in trust for the benefit of the *sukuk* holders. Thus, under such transaction structure, the legal nature of a *sukuk* certificate is a trust certificate issued by the SPV in its capacity as the trustee of the underlying *Sharia*-compliant assets, and each investor holding *sukuk* certificates has a beneficial

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[31] Moini, *supra* note 4, at 36.

[32] Rahail Ali, *An Overview of the Sukuk Market*, in *SUKUK* AND ISLAMIC CAPITAL MARKETS 7, 8 (Rahail Ali ed., 2011).

[33] Because of the nature of the assets, or the practical and legal issues in obtaining custody or possession thereof, normally, it would not be possible to sell the underlying assets in the market. *See id.*

[34] The SPV is usually structured as an orphan company.

co-ownership interest (on a pro rata and undivided basis) in those assets.

The earliest and predominant structure of *sukuk* issued to date has been the *sukuk al-ijara*, whose structure is in many ways similar to a sale and leaseback structure used in conventional finance practice. Following the earliest *sukuk al-ijara*, many other *sukuk* structures such as *sukuk al-musharaka*, *sukuk al-mudarabah*, and *sukuk al-murabaha* have been developed in the market.[35]

III. LEGAL AND OTHER OBSTACLES FOR KOREAN COMPANIES TO ISSUE *SUKUK*

Under a structure involving the SPV, a Korean company as an originator will enter into *Sharia*-compliant contracts with the SPV in connection with underlying *sukuk* assets. The SPV will then declare a trust over the assets and undertake to hold the assets as trustee on behalf and for the benefit of the *sukuk* holders. The legal and tax implications differ depending on in which jurisdiction the SPV is established.

A. The Offshore SPV Structure

An offshore SPV (an Offshore SPV) is a foreign company from a Korean law perspective. The issuance of *sukuk* and its offshore placement (i.e., offering *sukuk* only to non-residents of Korea) by an Offshore SPV is a matter to be governed by the laws of the jurisdiction where such the SPV is established. Hence, if *sukuk* are offered to Islamic investors who are not residents of Korea, the only aspect where Korean law would apply would be in relation to the underlying transactions entered into between an onshore originator (a Korean Originator) and an Offshore SPV. Under the Foreign Exchange Transaction Regulations (FETR), certain transactions between a resident and a non-resident of

[35] Among the fourteen *Sharia*-compliant *sukuk* structures recognised by the Accounting and Auditing Organisation for Islamic Financial Institutions, only five of them (*ijarah, mudarabah, musharaka, murabaha* and *istithmar*) hold up to 90% of the *sukuk* market share. Of these, *ijarah* has been the most popular structure used by international *sukuk* issuers, occupying 52% of market share in the international *sukuk* issuance as of 2009. *See* Moinuddin Malim & Mashreq Al-Islami, *The Future of Sukuk: Islamic Capital Markets*, in *SUKUK* AND ISLAMIC CAPITAL MARKETS 167 (Rahail Ali ed., 2011).

Korea are subject to reporting requirements.[36] Depending on the type of assets involved and the structure of the *Sharia*-compliant contracts, the reporting requirements under the FETR vary and may arouse some complications from a regulatory and/or administrative perspective. Still, no such complications would likely pose a real hurdle in practice. The real hurdle is the heavy tax burden involved in *sukuk* transactions, making *sukuk* much less tax efficient than conventional bonds. For these reasons, although it is legally possible to issue *sukuk* using an Offshore SPV, the Offshore SPV structure has not yet been considered as a practical investment option for investors in the market.

B. The Korean SPV Structure

The issuance and placement of *sukuk* by an onshore SPV (Korean SPV) are subject to Korean laws, even if they are placed outside Korea. 'Negotiable security' (*Wertpapiere* in German and *Yuga-jeungkwon* in Korean) is a legal term of art referring to an instrument representing rights and interests, and its possession is required for the creation, transfer and/or exercise of those rights and interests.[37] As possession of *sukuk* certificates is necessary for *sukuk* holders to transfer and exercise the beneficial interest in the underlying *sukuk* assets, *sukuk* constitute negotiable securities. The "*numerus clausus* principle of negotiable securities,"[38] which is one of the fundamental legal principles of interpreting Korean laws, requires a negotiable security to be acknowledged and given legal effect only to the extent expressly provided in the statutes. Hence, a Korean SPV may issue *sukuk* only if they fall within the scope of negotiable securities authorized by the Korean statutes. Although the "*numerus clausus* principle of negotiable securities" is a legal term of art, it is not expressly provided anywhere in the

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[36] Section 2 of the Foreign Exchange Transactions Act (FETA) provides that the transactions between non-residents and residents are subject to the FETA. The FETR is a regulation of the FETA prepared by the Ministry of Finance to provide details for application of the FETA.

[37] HONG-GI KIM, LECTURE ON COMMERCIAL CODE 877 (2015).

[38] Under this principle, which originated from the German law principle *Der Numerus Clausus der Wertpapiere*, the types and the contents of the negotiable securities are restricted to those permitted by statutes because negotiable instruments are to be effective against third parties as well as against the parties who created it. *See* Young-Shin Yoon, *Is It Prohibited to Issue Corporate Bonds Which Are Not Provided in the Statute?*, 22-1 COMMERCIAL LAW REVIEW 461, 464 (2003).

statutes. So when it comes to specific details of this principle and how strictly this principle is applied, legal scholars reach different conclusions on whether certain provisions in the statutes can be considered sufficient legal ground for issuance of a specific type of negotiable security.

1. Debates on the Scope of Permissible Securities by Korean Corporation (Chusik-hoesa)

Before 2011, Sections 523-526 of the Korean Civil Code generally provided for the rights and obligations of the parties and other legal effects of bearer-form debt securities. However, the Commercial Code of Korea (Commercial Code) specifically authorized only three types of negotiable securities for Korean corporations, namely, bonds (s. 469), [39] convertible bonds (s. 513), and bonds with warrants (s. 561-1). Further, provisions in Chapter 3-2 of the Financial Investment Services and Capital Markets Act (Capital Markets Act) expressly authorized issuance of profit-participating bonds and exchangeable bonds by listed corporations.

These statutory provisions, when taken together, raised a question whether an unlisted corporation can issue profit-participating bonds and exchangeable bonds in the absence of an express statutory provision specifically authorizing their issuance. This triggered an ongoing debate about the precise scope of negotiable securities that can be issued by a Korean corporation. Depending on how one viewed the relationship between these statutory provisions, legal scholars reached different conclusions.

On one hand, there was an expansionary approach (Expansionary Approach) which views Sections 523-526 of the Korean Civil Code as providing a sufficient legal ground to satisfy the requirements of the *numerus clausus* principle of negotiable securities for the general issuance of bearer-form debt securities. According to this approach, no further authorization was needed for a Korean corporation to issue bearer-form debt securities.[40]

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[39] While the Commercial Code does not provide a definition of the term "bonds," it is usually understood as "debt incurred by a corporation, directly or indirectly, from the general public by issuing debt instruments in a collective and standardized way." *See* JUNESUN CHOI, THE LAW OF CORPORATION 606 (9th ed. 2013).

[40] *See* Yoon, *supra* note 38, at 471-72; *See also* Sung-Po An, *Debt Securities and the Numerus Clausus Principle of Negotiable Instruments*, 17-4 THE JOURNAL

The provisions in the Commercial Code and the Capital Markets Act were enacted only to facilitate the issuance of the specific types of bonds statutorily listed and not to limit the capability of a corporation to issue bearer-form debt securities other than as provided in the Commercial Code and Capital Markets Act.[41] Thus, a Korean company could issue, not only conventional bonds but any other type of bearer-form debt securities under then existing legal framework.

On the other hand, there was an exhaustive approach (the Exhaustive Approach),[42] which viewed the Commercial Code as placing a definite boundary on the scope of bonds that could be issued by a Korean corporation. Those supporting the Exhaustive Approach asserted that, if the Capital Markets Act (which is a special legislation on the Commercial Code) expanded the scope of permissible bonds only for listed corporations, it was logical to infer that companies in general cannot issue bonds that are not specifically listed in the Commercial Code, unless otherwise expressly allowed. Thus, a Korean corporation could issue only bonds, convertible bonds, and bonds with warrants (unless otherwise specifically authorized by another statute, such as the Capital Markets Act). The Financial Supervisory Service of Korea (FSS) supported the Exhaustive Approach.

Under the Exhaustive Approach, the precise scope of permissible bonds for a Korean corporation would depend on what was actually meant by the term "bond" as used in the Commercial Code. There was no doubt that "bond," as used in code, encompassed the conventional plain vanilla bond where the issuer is obligated to repay the principal amount upon maturity together with interest at a pre-determined rate,[43] but what else could be

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OF COMPARATIVE PRIVATE LAW 341, 348 (2010); Byoung Seon Choe, *Issue of Foreign Currency Denominated Exchangeable Bonds Outside of Korea*, 3-2 THE KOREAN JOURNAL OF SECURITIES LAW 95, 102-104 (2002).

[41] According to Young-Shin Yoon, the legislative purpose of the provisions in the old Securities Transaction Act (which are incorporated into the current Capital Markets Act) allowing listed corporations to issue exchangeable bonds and profit participating bonds was to help listed corporations out of uncertainties due to these controversies. However, this caused side-effects by arousing misunderstanding as to the capability of non-listed corporations to issue these bonds. *See* Yoon, *supra* note 38, at 482.

[42] Under this approach, the provisions in the Korean Civil Code are only dealing with the legal effects of debt securities that are duly issued rather than providing a specific legal ground authorizing issuance of debt securities.

[43] Section 474 of the Commercial Code requires the bond subscription offer prepared by a corporation to specify the principal amount, redemption date and

captured by this term "bonds" was not clear. Thus, if any deviation was sought to modify these basic attributes of fixed maturity date and interest payment, it was not clear whether such securities would still be within the boundary of "bonds."

FSS took a very narrow stance on this point,[44] which hindered introduction of innovative financial products into the Korean capital market.[45] Before 2011, only listed corporations could actually issue profit-participating bonds and exchangeable bonds under the Capital Markets Act.[46] In 2011, the Commercial Code was revised. Existing Section 469[47] became Section 469(1) and the following new paragraph 2 was added to Section 469:

> (2) The bonds mentioned in paragraph (1) include the following bonds:
> (i) profit-participating bond;
> (ii) a bond that may be exchanged or redeemed with shares or other types of negotiable instruments; and
> (iii) a bond whose repayment amount or payment amount is determined pursuant to a pre-determined method, which is linked to the fluctuation of the negotiable instruments, currency, or such other assets or indices prescribed in the presidential decree.

The amendment is considered a double-edged sword. The

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method, interest rate, and method of interest payment. From this provision, it can be inferred that the Commercial Code contemplates bonds to be a fixed-income debt instruments with set maturity and interest payment.

[44] Young-Shin Yoon, *Analysis of the Provisions Concerning Corporate Bonds under the Draft Amendment Bill of Commercial Code,* 28-3 COMMERCIAL LAW REVIEW 297, 303 (2009).

[45] Long before the actual amendment of the Commercial Code in 2011, there were voices in the finance market requesting amendment of the Commercial Code to allow unlisted corporations to issue exchangeable bonds. Also, considering that an amendment of the Commercial Code would be a time-consuming process, it was suggested that a special statute should be adopted to allow at least venture capital companies to issue exchangeable bonds during the interim period until the Commercial Code was actually amended. *See* Hyungtae Kim, *The Study on the Institutional Improvement Necessary for Vitalization of the Structured Bonds*, KOREA SECURITIES RESEARCH INSTITUTION, RESEARCH REPORT, 60-61 (2001), http://www.kcmi.re.kr/report/report_view.asp?rno=115.

[46] Wanjin Choi, *Special Bonds*, in 3 THE COMPENDIUM OF THE CORPORATE LAWS 94, 131, and 135 (2nd ed. 2016).

[47] Section 469 merely provided that "A corporation may issue bonds pursuant to the resolution of the board of directors."

purpose of adding Section 469(2) was to remove legal uncertainties related to the issuance of diverse bonds by providing an express legal ground for diverse bonds belonging to a certain category.[48] Given such legislative background, the amendment may further strengthen the ground for taking the Exhaustive Approach.[49] Arguably, the permissible bonds under the Commercial Code are not strictly restricted to those specified in the list because the literal language of Section 469(2) indicates that the list is exemplary.[50] Still, it is likely that the scope of permissible bonds will be limited to those similar to the ones specified in the code. After all, while it is now clear that these specifically listed variations are permissible, it is still unclear what other exotic securities can be issued by a corporation.

2. Possibility of the *Sukuk* Issuance before Amendment of the Trust Act in 2011

Before 2011, there were different views as to the possibility of a *sukuk* issuance by a Korean SPV, depending on which of the foregoing approaches was taken. As *sukuk* did not neatly fit into any category of permissible securities under the Commercial Code or the Capital Markets Act, its issuance would not be allowed at all under if one took the Exhaustive Approach. Even under the Expansionary Approach, an issuance of *sukuk* by a Korean corporation would be permissible only if *sukuk* can be construed as debt instruments. There is an affirmative view asserting that *sukuk* can be issued under the current legal framework because *sukuk* fall within the category of debt instruments.[51] However, it is rather difficult to accept this approach.

As discussed in Section II, although *sukuk* bear a strong resemblance to conventional corporate bonds, *sukuk* are not IOUs and the issuer bears no obligation to make payment independent of *sukuk* assets. The payment under *sukuk* actually comes from the

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[48] *See* Doowhan Kim, *Issuance and Placement of Bonds,* in 3 THE COMPENDIUM OF THE CORPORATE LAWS 43, 53 (2nd ed. 2016); *see also* OKRYUL SONG, LECTURES ON COMMERCIAL CODE, 1151 (6th ed. 2016); *See* KUN-SIK KIM ET AL., THE CORPORATION ACT 444 (4th ed. 2013).

[49] Interpreting Section 469(2) as 'a legal ground for issuance of the type of bonds provided therein' supports the argument that Sections 523-526 of the Korean Civil Code alone cannot be a sufficient legal ground for issuing debt securities.

[50] *See* Doowhan Kim, *supra* note 48, at 53.

[51] Sang-Chul Lee, *A Study on Introducing of Islamic Bond, Sukuk,* 17-2 LAW & POLICY REVIEW 289, 315-19 (2011).

obligor under the *Sharia*-compliant contracts signed with the issuer, and the purchase obligation of the obligor is subject to the existence of the assets. Thus, *sukuk* holders bear the risks connected with ownership of the underlying *sukuk* assets. Due to these attributes, it is difficult to agree that *sukuk* can be classified as debt instruments. Therefore, whichever approach is taken, it seemed difficult, if not impossible, for a Korean SPV to issue *sukuk* under the legal framework existing as of 2011. This is why the main focus of Korean government's Islamic finance reform efforts in 2009-2010 was different for the Korean SPV and Offshore SPV structures. While the efforts contemplated in connection with the former focused mainly on taking measures to eliminate legal uncertainties preventing an issuance of *sukuk* by a Korean SPV, the efforts related to the latter focused on merely increasing tax efficiency.

3. New Possibility pursuant to the Amendment of the Trust Act in 2011

The previous discussions on the possibility of using a Korean SPV to issue *sukuk* as mentioned in paragraph 2, above, was based on the premise that *sukuk* cannot be issued as trust securities[52] under laws of Korea. Before 2011, the only statute that provided for the issuance of trust securities was the Capital Markets Act. Section 4(5) of the Capital Markets Act defined 'trust securities' subject to the Capital Markets Act as (i) the trust securities issued pursuant to Sections 110 and 189 by the trust business entities authorized to conduct trust business by the Financial Services Commission of Korea (FSC) or (ii) such other similar instruments representing beneficial interests of a trust. As the Trust Act had no provision regarding the issuance of trust securities before 2011, however, sub-paragraph (ii) was actually a dead letter. No other trust securities could be issued, due to lack of legal grounds, other than those issued by the trust business entities mentioned in sub-paragraph (i). Hence, it was not possible for an SPV, which was not an authorized trust business entity, to issue trust securities before 2011.

[52] A trustee may deliver a certificate evidencing the creation of the trust (just like a loan agreement evidencing the loan). However, for such trust certificate to be tradable as negotiable securities, there should be legal grounds for its issuance. In this article, the phrase 'trust securities' shall be used to refer to those trust certificates issued by a trustee as negotiable securities.

Now, the 2011 amendment of the Trust Act has opened a new possibility for Korean SPVs. Section 78(1) of the amended Trust Act now expressly permits a trustee to issue trust securities without any restriction on the qualification of the trustee, provided that the trust deed or the declaration of the trust provides so. Hence, since 2011, it has become possible for a Korean SPV to issue trust securities if authorized by the trust deed or the declaration of the trust.

Consequently, a Korean SPV can now issue *sukuk* in the form of trust securities by virtue of the amended Trust Act, regardless of the conclusions reached by the earlier debates.[53] As with the case of a *sukuk* issuance using an Offshore SPV, however, an issuance of *sukuk* by a Korean SPV also involves heavy tax burdens, again making such issuance much less tax efficient than conventional bonds.[54] For these reasons, it is not yet considered as an economically viable financing option and there has been no actual *sukuk* issuance by a Korean SPV, to date.

4. The Need to Remove Tax Barriers

As discussed in Section II, there exist some fundamental differences between *sukuk* and conventional bonds, which lead to adverse tax consequences for *sukuk* in many countries, including Korea. Specifically, as *sukuk* transactions involve transfer of property which triggers various taxes in most jurisdictions, *sukuk* are generally subject to heavier tax burdens than their conventional counterparts, increasing the cost of issuance well above conventional bonds. As such, the international *sukuk* market had historically been limited by the potentially adverse tax treatments of *sukuk*.[55] In order to attract investments from *shariah*-compliant managed funds and other overseas *sharia* investors and effectively utilize 'petrodollar liquidity,'[56] it is

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[53] Mee-Hyon Lee, *The Issuance of Sukuk under the Current Legal Regime Of Corporate Finance*, 34-1 COMMERCIAL LAW REVIEW 183, 215-218 (2015).

[54] *See infra* Section VIII.C.1. (explaining tax effects in detail).

[55] International *sukuk* issuances, as a percentage of the total issuances during 2010-2014, were within the range of 10%-14%. *See* STANDARD & POOR'S RATING SERVICES, ISLAMIC FINANCE OUTLOOK 2016 EDITION 7 (Sep., 2015), https://www.spratings.com/documents/20184/86966/Islamic_Finance_Outlook_2016_v2/4d9d6fd9-3b11-4ae2-9168-13ee2543b73b.

[56] This 'petrodollar liquidity' refers to oil rich nations' domestic economies being too small to absorb all capital inflows from oil export revenues, thereby giving them greater liquidity. Brett Freudenberg & Mahmood Nathie, *Tax and*

essential to remove the tax barriers that make *sukuk* less tax efficient than conventional bonds so that Islamic finance providers are given the same opportunities as conventional debt buyers.

Against this backdrop, regulatory and tax changes to facilitate *sukuk* issuances are already in place and foreshadowed in many countries. For example, the UK governments has, in a series of Finance Acts since 2003, removed some of the tax barriers that made *sukuk* less tax efficient than conventional bonds. The Finance Act 2009, which received Royal Assent on 21 July 2009, enacted additional measures for *ijara sukuk* to ensure that, from a tax perspective, everything is in place for a UK corporate to issue *sukuk* based on an *ijara* of real estate assets.[57] Due to such efforts, in June 2014, the UK succeeded in selling *sukuk* in the amount equal to £200 million to investors based both in the UK and in the major hubs for Islamic finance around the world, becoming the first western country to issue sovereign *sukuk*.[58]

France also has been taking pro-active steps to promote Islamic finance since 2008. On 2 July 2008, both the French Ministry of Economy, Industry, and Employment and the Autorité des Marchés Financiers (AMF), the French financial markets regulatory authority, announced significant tax and regulatory changes aimed at boosting Islamic finance in France.[59] In 2011, Japan amended the Act on Securitization of Assets (Asset Securitization Act) to encourage the issuance of *sukuk al ijara* and further amended Tax Special Measurement Law to provide certain tax advantages to *sukuk al ijara* issued pursuant to the amended Asset Securitization Act.[60] Hong Kong also joined this trend in

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Religion: Never the Twain Shall Meet?, 9th INTERNATIONAL TAX ADMINISTRATION CONFERENCE (Sydney) April 8-9, 2010, at 4, (May 7, 2010) http://ssrn.com/abstract=1601696.

[57] *See* Farmida Bi & Angela Savin, *Sukuk Issuances: the Future*, PLC MAGAZINE, Aug. 21, 2009, http://uk.practicallaw.com/7-422-4272?q=Sukuk+Issuances .

[58] Manu Mair & Mehreen Khan, *Britain to Lead the World in Islamic Finance*, THE TELEGRAPH, Feb 26, 2015, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11435465/Britain-to-lead-the-world-in-Islamic-finance.html; UK Trade and Investment, UK EXCELLENCE IN ISLAMIC FINANCE, Oct. 2014, at 3, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367154/UKTI_UK_Excellence_in_Islamic_Finance_Reprint_2014_Spread.pdf.

[59] Laurence Toxé, *France Gives Islamic Finance a Boost*, NORTON ROSE FULBRIGHT PUBLICATIONS, September 2008, http://www.nortonrosefulbright.com/knowledge/publications/16965/france-gives-islamic-finance-a-boost .

[60] *See generally* Naoki Ishikawa, *Japan: New legislative framework for Sukuk*,

2013. On 19 July 2013, the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 was gazetted to conform tax treatment for *sukuk* to conventional debt securities to create a more level playing field.[61] There have been calls in Australia for similar reforms to be considered.[62]

Given this trend, Korea needs to be more proactive to ensure that its tax laws do not unduly hinder *sukuk* transactions, if Korea is to have a share of petrodollar liquidity. Islamic finance is a rapidly growing part of the global financial system these days. Unless an easy access to Islamic finance is ensured, Korean companies' financing opportunities will be substantially limited. Especially, in this period of financial market stress, the need to attract petrodollar liquidity has become increasingly important. The sources of capital in the western world have almost dried up since the global financial crunch, but there is still huge capital available in the Gulf countries.[63] The volume of global *sukuk* issuance dropped during the global financial crisis but rapidly revived, enjoying a very successful run that began in 2010 and recorded another pinnacle in 2012 (US$ 137 billion).[64] This shows that *sukuk* are actually being utilized as an efficient option for mid- and long-term financing in the global financial market.

Korea would benefit from recognizing that Islamic finance is now moving from being a niche to the mainstream as a viable and valid financing option for all. It appears an inevitable financing option if Korean companies are not to be left behind in the competition with their global partners. The first step to enable Korean companies to tap Islamic capital is to facilitate issuance of

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ISLAMIC FINANCE NEWS, June 8, 2011, at 27 http://www.islamicfinancenews.com/authors/naoki-ishikawa; Financial Services Agency, *Taxation of J-Sukuk Q&A*, FINANCIAL SERVICES AGENCY, INFORMATION BROCHURE, April 2016, http://www.fsa.go.jp/en/news/2012/20120416-1/01.pdf.

[61] Qudeer Latif, *Hong Kong Takes Steps Towards Becoming a Centre for Islamic Finance*, CLIFFORD CHANCE, CLIENT BRIEFING NOTE, Summer 2013, at 1-5, http://www.cliffordchance.com/briefings/2013/08/hong_kong_takes_stepstowards becomingacentr.html.

[62] Soraya Permatasari & Marion Rae, *Australia Seeks Tax Changes on Sukuk: Islamic Finance*, BLOOMBERG BUSINESS (Oct. 21, 2010), http://www.bloomberg.com/news/articles/2010-10-20/australia-planning-tax-changes-to-promote-sales-of-sukuk-islamic-finance (last visited Sep. 9, 2016).

[63] Simon Hooper, *UK aims to Become Centre for Islamic Finance*, AL JAZEERA, Nov. 1, 2013, http://www.aljazeera.com/indepth/features/2013/10/uk-aims-become-centre-islamic-finance-201310319840639385.html.

[64] INTERNATIONAL ISLAMIC FINANCE MARKET, *supra* note 1, at 10.

sukuk by Korean companies. Thus, moving tax barriers to create a more level playing field between conventional bonds and *sukuk*, which is aimed to tax neutrality as opposed to tax favoritism, is no longer an option but an inescapable choice.

IV. BACKGROUND FOR THE PREVIOUS TAX REFORM FOR *SUKUK* PURSUED BY THE MINISTRY OF STRATEGY AND FINANCE

A. Discussions of the Special Task Force Team for Sukuk in 2009

Shortly after the outbreak of the Global Financial Crisis in 2007, the Ministry of Strategy and Finance of Korea (MOSF) decided to utilize Islamic capital to alleviate serious funding difficulties faced by Korean companies and launched a special task force team[65] in early 2009 to promote *sukuk* issuance by Korean companies. During the task force team meetings,[66] FSS officials expressed a view that a Korean SPV was not allowed to issue *sukuk* under the then current legal framework, which was in line with the FSS' previous stance taken in connection with the issuance of profit-participating bonds or exchangeable bonds by unlisted corporations. This meant that some sort of legislative work was necessary to lay a statutory foundation for an issuance of *sukuk* by a Korean SPV. Separate from the initiatives for *sukuk* issuances, the FSS was, at that time, preparing a draft bill under the direction of the FSC for an overall reshuffling of the Capital Markets Act to reflect the then growing needs for supplementing and modifying the regulatory framework of the Korean capital markets. FSS officials proposed adding necessary provisions in the draft bill to lay a statutory foundation for *sukuk* issuances by listed Korean companies using a Korean SPV, just like the provisions of the Capital Markets Act authorizing issuance of profit-participating bonds and exchangeable bonds by listed companies.

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[65] The members of this task force team consisted of the officials of the MOSF and the FSS as well as financial experts, accounting, and legal professionals from private fields. The author also participated in this task force team.

[66] The discussions of the task force team are not published and the description in this article is based on the author's experience as a member of the task force team.

The work needed was not as simple as first thought. Since both profit-participating bonds and exchangeable bonds fell within the concept of debt securities under the Capital Markets Act, there was no doubt that these bonds constitute 'securities' under the Capital Markets Act. Thus, merely adding a simple provision allowing issuance of these bonds had been more than sufficient to authorize their issuance. However, as *sukuk* did not neatly fit into any of the sub-categories of securities provided in the Capital Markets Act, there remained questions as to whether *sukuk* constitute "securities" under the Capital Markets Act. If not, it was not a matter to be dealt with under the Capital Markets Act, in which case, the concept of "securities" under the act first needed to be expanded to include "*sukuk*" before any provision allowing their issuance could be added to the act.

Section 4(1) of the Capital Markets Act defines "securities" as financial investment instruments issued by a Korean citizen or a foreigner, for which investors do not owe any further obligation to pay anything on any ground, other than the money (or any equivalent) that the investors initially paid at the time of acquiring such instruments. At the same time, Section 4(2) of the Capital Markets Act classified "securities" into six different sub-categories, namely, debt securities, equity securities, trust securities, investment contract securities, derivatives-combined securities and securities depositary receipt. The Capital Markets Act further defined the scope of each of these sub-categories. The generally accepted interpretation on the correlation between Sections 4(1) and 4(2) was that, in order to constitute securities under the Capital Markets Act, it should not only be covered under the definition of "securities" but also fall under any one of those six sub-categories.[67]

There was no doubt that *sukuk* would be captured under the definition of "securities" in Section 4(1), but it was not clear as to which of the sub-categories *sukuk* should fall into. Among the six sub-categories, the two most relevant were "debt securities"[68]

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[67] JAI YUN LIM, CAPITAL MARKET LAW 35 (3rd ed. 2012).

[68] The Capital Markets Act, s.4(3) provides as follows:

> The term 'debt securities' in this Act means state bonds, local government bonds, special bonds (referring to bonds issued by a company established by direct operation of an Act; hereinafter the same shall apply), corporate bonds, corporate commercial papers (referring to promissory notes issued by a company for raising the funds required for its business, which shall meet the requirements

and "trust securities."[69] As noted in Section III.B.(3), until 2011, only trust business entities authorized by the FSC pursuant to the Capital Markets Act could actually issue trust securities. Expanding the scope of such trust businesses to SPVs would be considered inappropriate, as it would have far-reaching implications on all transactions involving trust in general (which would not have been intended). So, classifying *sukuk* as trust securities was considered inapt to resolve the problem.

Another possibility was to recognize *sukuk* as "debt securities," however, the FSS' official position was that the concept of "debt securities" under the Capital Markets Act captures only those securities representing conventional debts. They were reluctant to expand the scope of "debt securities" to anything beyond this and did not accept the argument that *sukuk* are debt securities under the act.[70]

Given the dilemma, a more practical solution seemed to involve adding a new sub-category for *sukuk*. As it happened, in recognition of the growing need to introduce diverse exotic securities into the Korean capital markets, amending Section 4(2) of the Capital Markets Act to create "alternative (innovative) finance investment securities" (Alternative Securities) covering diverse exotic securities as a new sub-category of "securities" was under consideration in the process of preparing the draft bill. The FSS officials ensured that the concept of Alternative Securities would be defined broadly enough to encompass *sukuk* and Section 165-11 of the Capital Markets Act would be amended to allow a listed company to issue certain Alternative Securities including *sukuk* using an onshore SPV.[71] Such amendment would have

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prescribed by the Presidential Decree; hereinafter the same shall apply), and other similar instruments, which bear the indication of a right to claim payment.

[69] Capital Markets Act, s.4(5) provides as follows:

> The term 'trust securities' in this Act means the trust securities under Section 110, the trust securities under Section 189, and other similar instruments, which bear the indication of a beneficial interest in a trust.

[70] From the regulatory perspective, anything that will be captured under the term "debt securities" should be subject to the same level of regulation. If the term "debt securities" is to be interpreted widely so as to encompass *sukuk*, it might inadvertently capture other exotic securities as well, which in the opinion of the FSC, should be treated differently from conventional debt securities. For these reasons, they were reluctant to take more flexible approach to broaden the scope of debt securities under Capital Markets Act.

[71] Section 165-11 belongs to a chapter applicable to listed companies. In light of

cleared all legal uncertainties surrounding a *sukuk* issuance and provided a legal basis for a *sukuk* issuance using a Korean SPV. This would indeed have been a step in the right direction for the long run.[72]

The only problem with this approach lay in the time constraints. As the Capital Markets Act was a complicated and voluminous piece of legislation,[73] an overall reshuffle of the act was considered as a task demanding enormous resources, time and efforts and, as such, no one could guarantee its timely completion. Back in 2009, the MOSF was under an enormous pressure to improve the gloomy financial conditions faced by Korean companies in an expedient manner. Hence, while pursuing the amendment of the Capital Markets Act was at priority, the MOSF decided instead to adopt a fast-track approach to delivering a quick output to the Korean capital markets that did not involve amendment of the Capital Markets Act.

B. Fast-Track Approach Taken by the MOSF

A fast-track approach taken by the MOSF was to facilitate the offshore issuance of *sukuk* using an Offshore SPV. As discussed in Section III.A., there was no serious legal hurdle for a Korean Originator to issue *sukuk* through an Offshore SPV. However, inherent in this structure were potentially complicated requirements under the FETR and tax burdens that made *sukuk* less tax efficient than conventional bonds.

Given the foregoing, the MOSF decided to remove these obstacles for offshore issuance so as to make overseas *sukuk* issuance economically viable. As the FETR was merely a regulation published by the MOSF, amending the FETR to remove the reporting-related obstacles was under its full control and, thus, the task involved was relatively straightforward. On the other hand,

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the fact that the amended Section 165-11 will not be directly applicable to an onshore SPV issuing *sukuk*, which will not be listed in most of the cases, it was contemplated that Section 165-11 will specifically allow a listed company to issue alternative finance investment securities through an onshore SPV. This issuance is subject to certain conditions such as the issuance is controlled by the listed company, financial statements are consolidated, etc.

[72] For the purpose of this discussion, the proposal to introduce Alternative Securities into the Capital Markets Act will be referred to as the Alternative Securities Scheme.

[73] The Capital Markets Act, in effect as of 2009, consisted of 449 sections, excluding the supplementary provisions.

removing tax burdens to bring *sukuk* on par with conventional bonds required amendment of the Special Tax Treatment Control Act (STTCA)[74] which involved the actions of the National Assembly. Still, as the MOSF was the ministry responsible for enforcement of the STTCA, preparation of the STTCA amendment bill was under its control. The officials of the MOSF expected, contrary to what actually happened, that the National Assembly would easily pass this bill. Once the STTCA was amended, the MOSF would amend the FETR to remove the reporting-related obstacles. The MOSF's fast track approach was adopted as a temporary means to achieving its objective under the expectations that tweaking relevant provisions of the STTCA would bring about easier and faster outcomes than amending the Capital Markets Act.

V. ANALYSIS OF TAX BURDENS FOR *SUKUK*

A. Types of Sukuk Considered by the MOSF

Among the many types of s*ukuk* that are available, the two types of *sukuk* that had come into the limelight in Korea by 2009 were *Sukuk-al-Ijara* and *Sukuk-al-Murabaha*. They are structured as follows:

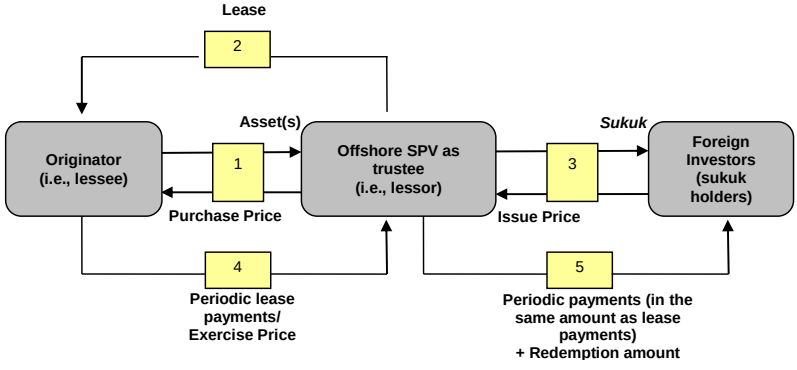
1. *Sukuk-al-Ijara*

(i) The SPV issues *sukuk* to investors to raise funds to finance the purchase of a certain asset.
(ii) The originator sells the underlying asset(s) to the SPV (which will hold the asset(s) on trust for the benefit of *sukuk* holders) for a pre-determined purchase price.
(iii) The SPV then leases the asset(s) to a third-party (often the originator itself) according to an *Ijara* (Islamic lease) agreement for a fixed period of time, in exchange for periodic lease payments. The payment obligations of the originator to the SPV under the *Ijara* agreement mirror the payment obligations of the SPV to investors holding *sukuk*.
(iv) Simultaneously with entering into the *Ijara* agreement, the

[74] The STTCA effective at that time: Josae teukryae jaehan beob [Special Tax Treatment Control Act], Act. No.9708, Aug. 23, 2009 (S. Kor.)

originator will grant a purchase undertaking in favor of the SPV, agreeing to purchase the underlying asset(s) back from the SPV at a pre-determined price (Exercise Price which should be an amount equal to any outstanding amounts still owed under *sukuk*).

(v) *Sukuk* represent an undivided pro rata ownership of the underlying leased asset(s) and *sukuk* evidenced such ownership.[75]



2. *Sukuk-al-Murabaha*

(i) The SPV enters into a *Murabaha* Master Agreement with the originator.

(ii) The SPV issues *sukuk* to the investors to raise funds to finance the purchase of a certain asset(s) and purchases the asset(s) for a price of X.

(iii) The SPV sells the asset(s) to the originator for a price of X plus a margin of P.

(iv) The originator pays X plus P to the SPV, usually in instalments over a certain period of time. (Resale of the asset(s) by the originator is not mandatory, but in many cases the originator resells the asset(s) to a broker or any third-party in the market for price of X.)

(v) The SPV pays the proceeds it has received from the originator to the investors.

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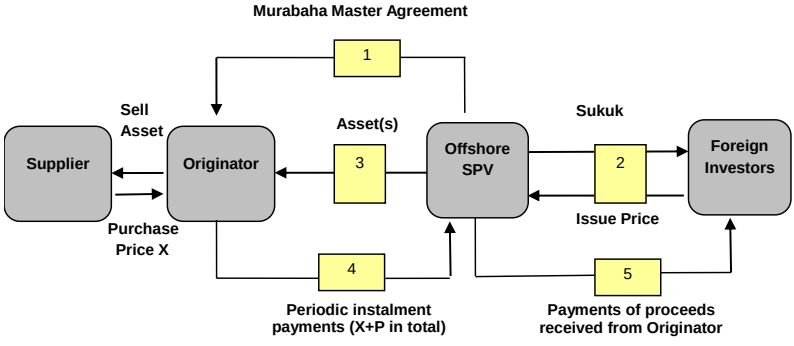
[75] *See* Ali, *supra* note 32, at 12-13.



The economic function of these *sukuk* was quite similar to that of conventional bonds.[76] However, due to the structure requiring transfer of assets, there was, and still there is, a number of tax consequences which would make an offshore foreign currency denominated *sukuk* issuance extremely unattractive compared to an offshore issuance of foreign currency denominated conventional bonds.

B. Withholding Tax Issues on the Payment Made to Offshore SPV

Generally, payment of income arising from domestic sources to a non-resident individual or a foreign entity (collectively, a foreign person) is subject to Korean withholding tax either under the Income Tax Act or the Corporate Income Tax Act, unless otherwise exempted. The Income Tax Act is applicable if the recipient is a non-resident individual and the Corporate Income Tax is applicable if the recipient is a foreign entity. Considering that the provisions of the Income Tax Act, which relate to imposition of withholding tax on an income from a domestic source paid to a non-resident individual, mirror the parallel provisions in the Corporate Income Tax Act, this discussion will, for simplicity, focus on the issues under the Corporate Income Tax Act only.

Some typical examples of domestic sources of income subject to withholding under the Corporate Income Tax Act are

[76] Due to such similarity to conventional bonds, some *Sharia* scholars have asserted that contemporary *sukuk* are not compliant with the original purpose of *Sharia*. *See* Malim & Al-Islami, *supra* note 35, at 169-172.

interest, dividend, and rent.[77] Currently, Section 21 of STTCA provides that no withholding tax will be imposed on "fees and interest on the foreign currency bonds issued by the Korean Government, local government entities, or a Korean company outside Korea, unless they are held by residents, domestic companies, and a permanent establishment of foreign companies" (interest eligible for the tax exemption under this section is referred to as Eligible Interest). So, if foreign currency bonds issued by a Korean company are held by a foreign person, the profits from such bonds will not be subject to any Korean withholding taxes.

In the above diagrams, the tax exemption applicable to Eligible Interest is not applicable to the payments made by the Korean Originator to the Offshore SPV in excess of the original amount received by the Korean Originator (which amount would be equal to the amount of the "profits of *sukuk"* in the hands of *sukuk* holders). Hence, generally speaking, profits from bonds are treated more favorably than profits of *sukuk* from a Korean tax perspective.

In case of *sukuk-al-murabaha*, the payments from the Korean Originator to the Offshore SPV will take the form of instalment payments for the purchase price. Currently, so long as the requirements provided in Section 68(4) of the Enforcement Decree of the Corporate Income Tax Act are met, instalment payments for the purchase price paid to a foreign person is not subject to withholding tax.[78] Hence, despite not qualifying as Eligible Interest, profits of *sukuk-al-murabaha* may still successfully avoid

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[77] Beobin saebeob [Corporate Income Tax Act], Act. No. 14386, Dec. 20, 2016, s.93 & s.98(1).

[78] In most instalment sales, the aggregate purchase price consists of the original purchase price plus interest thereon. In principle, this interest portion will be subject to withholding of Corporate Income Tax. However, for certain long-term instalment sales meeting the requirements of Section 68(4) of Enforcement Decree of the Corporate Income Tax Act, withholding tax on the interest portion is exempt pursuant to Section 72(5) of the act. For such qualifying long-term instalment sales, if the taxpayer entered in its book only the original purchase price as the acquisition price, and the interest portion is entered into as unrealized balance, only the original purchase price, entered as the acquisition price, will be subject to depreciation, but no withholding tax will be imposed on the interest portion. Further, for such qualifying long-term instalment sales, the taxpayer may also choose to enter in its book the entire aggregate purchase price (including the interest portion) as the acquisition price of the asset. In such event, the aggregate purchase price will be subject to depreciation, thereby eliminating the issue of withholding tax.

withholding tax by structuring the transaction in a way that would satisfy these requirements.

On the other hand, in case of *sukuk-al-ijara*, the payments from the Korean Originator to the Offshore SPV will take the form of rents, which are subject to withholding taxes. Specifically, if the lease involved in *sukuk-al-ijara* is an operating lease, the rents are subject to withholding of Corporate Income Tax at 2% pursuant to Section 98(1)(i) the Corporate Income Tax Act.[79] In a sale and lease-back transaction, if the lease involved is a finance lease, the interest portion of the rent payment will be carved out and classified as interest (but this interest is not Eligible Interest) so that it will be subject to withholding tax at the rate of 20%.[80] Unlike *sukuk-al-murabaha*, there is no other tax relief available to exempt the rents from withholding taxes. Thus, the tax consequences for the holders of *sukuk-al-ijara* would always be less attractive compared to the holders of conventional bonds receiving Eligible Interest.

C. Transaction-Related Taxes Resulting from the Transfer of Underlying Assets

Under Korean tax laws, a transfer of assets involves a number of tax consequences as follows:

(i) **Acquisition Tax and Registration Tax:** As a sale and purchase of certain assets are subject to acquisition tax and registration tax, a transfer of assets initially from the Korean Originator to the Offshore SPV, and then back to the Korean Originator, may trigger these taxes, depending on the type of assets underlying *sukuk*.[81] While most of the assets used in

[79] The actual withholding rate may be reduced or exempted subject to the relevant double tax treaties.

[80] In a sale and lease-back (finance lease) transaction, for tax purposes, the sale transaction is disregarded and the whole transaction is treated as a secured loan. The excess portion is treated as interest. Beobin saebeob Gibon tongchik [Basic Ruling of Corporate Income Tax Act] no.23-24…1, s.7(2); Lease hoegye gijoon [Accounting Standard for Leases], s.23-2.

[81] Jibang saebeob [Local Tax Act], Act. No. 13797, Jan. 19, 2016, s.10 (S. Kor.). At that time, both the acquisition tax and the registration tax were imposed for an acquisition of assets requiring registration. So, the tax relief prepared by the MOSF included tax waiver for registration tax as well. The Local Tax Act was later revised to the effect that no registration tax is imposed for registration filed for acquiring assets, provided that the acquisition tax is paid. Hence, at the

sukuk-al-murabaha transactions do not fall under this category, most of the assets that are likely to be used for *sukuk-al-ijara*[82] would fall within this category.

(ii) **Value Added Tax ("VAT"): The** supply of assets or services is subject to VAT at the rate of 10%.[83] As a lease transaction involves the supply of leasing service, it will be subject to VAT equal to 10% of the lease payment.

(iii) **Corporate Income Tax:** The capital gains made by the Korean Originator from the sale of the assets to the Offshore SPV, and the capital gains made by the Offshore SPV upon its resale to the Korean Originator, will be added to the tax base as profits in calculating the Corporate Income Tax, so as to increase the total amount of the Corporate Income Tax payable by these parties.[84]

Thus, unless such transfers of assets could be disregarded for tax purposes, *sukuk* may be subject to extra costs. However, it is questionable whether individual transactions forming a part of the overall *sukuk* transaction would be viewed as a "single" finance transaction so that the underlying asset transfers can be disregarded for the purposes of these taxes.

VI. PROPOSED TAX REFORM FOR THE OFFSHORE SPV STRUCTURE

The Korean withholding tax on the profits of *sukuk*, and transaction-related taxes arising from transfers of underlying assets, are additional tax burdens imposed on *sukuk* transactions compared to conventional foreign currency bonds generating Eligible Interest. Unless such taxes are exempt, many of the attractive features of *sukuk* as one of the methods of raising funds would be outweighed by the inherent tax-related costs.

In 2009, the MOSF decided to take measures to amend the

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time the asset is first acquired, no registration tax is imposed in addition to the acquisition tax now.

[82] For example, this includes real estate property, aircrafts, ships, and equipment.

[83] Buga gachi saebeob [Value Added Tax Act], Act. No. 14387, Dec. 20, 2016, s.4 and s.30 (S. Kor.).

[84] Unless otherwise excluded, any profits from a transaction which increases the total net assets of a company will be added to the tax base. Beobin saebeob [Corporate Income Tax Act], Act. No. 14386, Dec. 20, 2016, s.15(1) (S. Kor.).

STTCA to remove these tax burdens to provide a level playing field for *sukuk* to make it an economically viable financing option comparable with conventional bonds. Considering the purpose of such tax reform, the MOSF decided to limit the scope of *sukuk* having such benefits. Thus, the STTCA amendment bill prepared by the MOSF providing tax relief for *sukuk* transactions (*Sukuk* Bill)[85] limited the eligible types of *sukuk* to *sukuk-al-ijara* and *sukuk-al-murabaha* only and further required that these transactions be structured in a way that is specifically provided in the *Sukuk* Bill, so as to ensure certain level of economic similarity to conventional bonds.

The *Sukuk* Bill introduced a new concept of "Particular Securities" which is defined as (i) foreign currency denominated securities, (ii) issued by a Korean company to non-residents or foreign companies, (iii) through a certain Offshore SPV (the details of which are to be provided in the Presidential Decree to the STTCA), (iv) for the purposes of financing funds without violating certain religious restrictions prohibiting payment of interest, (v) through the use of a specific transaction structure as expressly provided in the STTCA. The key aspects of the proposed amendment involved treating a series of transactions contemplated in a *sukuk* transaction as a "single" financial transaction having substantially the same effect as issuing a foreign currency-denominated bonds.

The practical implications of such an amendment would include:

(i) Granting tax exemptions for withholding tax on any investment returns earned by an Offshore SPV issuing Particular Securities in excess of its original investment amount, thereby allowing the same tax benefits for profits as granted to the Eligible Interest; and
(ii) Granting tax exemptions for transaction-related taxes arising in connection with multiple transfers of the underlying assets among the parties.

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[85] Josae teukryae jaehan beobahn [The STTCA Amendment Bill] Bill No. 6159 submitted by the MOSF to the National Assembly on Sep 28, 2009 was a comprehensive tax bill including diverse tax privileges for various transactions. The tax treatment related to *sukuk* transactions was provided in Sections 21-2, 119 and 120 of this STTCA Amendment Bill. These Sections 21-2, 119, and 120 of the STTCA Amendment Bill will be collectively referred to as the "*Sukuk* Bill" in this paper unless specific section number is noted.

A. Analysis of Tax Benefits for Sukuk-al-ijara

1. The Structure Eligible for Tax Benefits

Pursuant to Section 21-1(1) of the *Sukuk* Bill, a *sukuk-al-ijara* transaction should be structured in the following way:

(i) An Offshore SPV purchases the underlying assets from a Korean Originator using the proceeds funded from its issuance of the "Particular Securities" to non-residents or foreign companies and, simultaneously, leases the underlying assets back to the Korean Originator for a lease period equal to the maturity of the "Particular Securities."
(ii) The Offshore SPV agrees with the Korean Originator to sell the underlying assets back to the Korean Originator upon expiration of the lease period, at a price equal to the initial purchase price.
(iii) The maturity of the "Particular Securities" is within the bounds stipulated by the Enforcement Decree of the STTCA.
(iv) The Korean Originator agrees to pay to the Offshore SPV the lease payments (before the maturity of the "Particular Securities") and the sales proceeds of the underlying assets (upon maturity of the "Particular Securities").

2. Tax Benefits Available for the Eligible *Sukuk-al-ijara*

Section 21-2(1) of the *Sukuk* Bill provides the following tax benefits for *sukuk-al-ijara* meeting the above requirements:

(i) Any lease payment made by the Korean Originator to the Offshore SPV will be regarded as an interest payment and the Corporate Income Tax thereon will be exempted.[86]
(ii) The asset leasing services provided by the Offshore SPV, the sale of the underlying asset(s) by the Korean Originator and the subsequent re-sale thereof by the Offshore SPV will not be viewed as supply of assets or services attracting the VAT.[87]

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[86] The *Sukuk* Bill, s.21-2(1).
[87] The *Sukuk* Bill, s.21-2(1).

Section 21-2(3) of the *Sukuk* Bill provides that, for the purpose of imposing corporate income tax on the Korean Originator and the Offshore SPV, the sale by the Korean Originator and the resale by the Offshore SPV shall be disregarded and the Korean Originator will, at all times, be deemed to be the owner of the underlying asset(s). Further, Sections 119 and 120 of the *Sukuk* Bill provide that the transfer of the underlying asset(s) between the Offshore SPV and the Korean Originator will not be subject to acquisition tax and registration tax.

3. Deprivation of Tax Exemptions

Upon the occurrence of any of the following events, the above tax exemptions will be cancelled retroactively:[88]

(i) The Offshore SPV does not resell the underlying assets to the Korean Originator at the end of the lease period.
(ii) The Offshore SPV sells the underlying assets to a third party before expiration of the lease period.
(iii) The actual resale price paid is different from the initial purchase price or the maturity of the Particular Securities exceeds the bounds stipulated by Enforcement Decree of the STTC, for reasons such as contract amendments.
(iv) The Korean Originator pays the resale price to the Offshore SPV before the maturity of the Particular Securities.[89]

If the tax exemption is cancelled upon an occurrence of any of the above events, (i) the exempted Corporation Income Tax (plus a certain amount of penalty tax calculated pursuant to Section 76(2) of the Corporate Income Tax Act) and VAT in the amount equal to 110% of VAT, which would otherwise have been imposed on the Issuing Company, shall be paid,[90] and (ii) the sale of the underlying assets between the Korean Originator and the Offshore SPV will be recognised as sale, so that the tax base of the Corporate Income Tax of the Korean Originator should be adjusted accordingly. Any additional amount of the Corporate Income Tax so calculated, plus interest calculated pursuant to the relevant provisions of Enforcement Decree of the STTCA, shall

[88] The *Sukuk* Bill, s.21-2(5).
[89] This is to prevent inflow of hot money under the disguise of long-term *sukuk*.
[90] The *Sukuk* Bill, s.21-2(5).

constitute the final amount of the Corporate Income Tax to be paid.[91]

B. Analysis of Tax Benefits for Sukuk-al-murabaha

1. The Structure Eligible for Tax Benefits

Pursuant to Section 21-2(2) of the *Sukuk* Bill, a *sukuk-al-murabaha* transaction should be structured in the following way:

(i) An Offshore SPV purchases a certain asset(s) from a third-party using the proceeds of issuance of the Particular Securities at a certain price X and re-sells these asset(s) to the Korean Company, at a price which is higher than the original purchase price: X+P.
(ii) The original purchase price and the subsequent sale price of the underlying asset(s) by the Issuing Company are pre-agreed among the Korean Company, the Offshore SPV, and the holders of the Particular Securities, before issuance of the Securities.
(iii) The Korean Company sells the underlying asset(s) within a period designated by Enforcement Decree of the STTCA.
(iv) The Korean Company pays to the Offshore SPV the amount corresponding to P (before maturity of the Securities) and the amount corresponding to X (on maturity of the Securities).

2. Tax Benefits Available for the Eligible *Sukuk-al-murabaha*

Section 21-2(2) of the *Sukuk* Bill provides the following tax benefits for *sukuk-al-ijara* meeting the above requirements:

(i) Any payment of P made by the Korean Company to the Offshore SPV will be deemed to be interest payments and Korean corporate income tax thereon will be exempted.
(ii) The sale of the underlying assets by the Korean Company and the subsequent sale thereof by the Offshore SPV will not be viewed as supply of assets that would attract VAT.

Further, Section 21-2(4) of the *Sukuk* Bill provides that for

[91] The *Sukuk* Bill, s.21-2(6).

the purpose of imposing corporate income tax on the Korean Company, the acquisition price of the underlying asset(s) will be deemed to be the value corresponding to the purchase price of the underlying asset(s) (i.e., X+P) plus any incidental costs, less the price differential treated as interest (i.e., P).

3. Deprivation of Tax Exemptions

Section 21-2(7) of the *Sukuk* Bill provides that if the Korean Company pays to the Offshore SPV the amount X before the maturity of the Particular Securities, the tax exemption given shall be cancelled retroactively, so that (i) the exempted corporate income tax plus an additional tax for late payment will be collected, and (ii) 110% of VAT amount that would otherwise have been imposed will be collected for supply of the asset.

VII. WHAT ACTUALLY HAPPENED?

A. The Initial Attempts by the MOSF in 2009

In late September of 2009, the MOSF submitted the *Sukuk* Bill to the National Assembly for its deliberation during its annual regular session.[92] For a tax bill to be adopted by the National Assembly, it is first deliberated at the tax sub-committee under the Strategy and Finance Committee. Once it is adopted by such tax sub-committee, it is then reviewed by the Strategy and Finance Committee. If a consensus is formed at the Strategy and Finance Committee, then the bill is submitted to the National Assembly plenary session for final adoption.

Despite the MOSF's intention to remove additional tax burdens on *Sukuk* arising from their *Sharia* compliant structure, such intention was met with an unexpected reaction on a religious ground. Some Christian groups opposing the *Sukuk* Bill alleged that, if adopted, the bill would grant an additional tax exemption in favor of Islamic bonds over other conventional bonds, with some extremist groups going so far as to suggest (however vexatious and frivolous) that the profits made from *sukuk* might flow into the

[92] The annual regular session of the National Assembly starts on September 1 each year and lasts for 100 days. *See* Gookhwae beob [National Assembly Act], Act. No. 14376, Dec. 16, 2016, s.4 and s.5-2.

hands of Islamic militant groups and be used for terrorism.[93] From the MOSF's perspective, there was no reasonable basis on which the members of the tax sub-committee could oppose the *Sukuk* Bill.

Because all unfounded statements made by the opposing groups were based on a literal interpretation of the *Sukuk* Bill in the absence of a full understanding knowledge and understanding of the Korean tax laws, the MOSF expected that the statements would fade away in time, which led them to underestimate the social influence the opposing groups had on the general community. Consequently, the MOSF merely made routine efforts that it would normally exert to have an ordinary bill adopted. To the MOSF's dismay, however, the tax sub-committee under the Strategy and Finance Committee, which was held on Dec 22, 2009, decided that the *Sukuk* Bill required more in-depth deliberation, shelving the bill until the provisional session of the National Assembly to be convened in February the following year.[94]

B. The Second Attempts by the MOSF in 2010

After being caught off guard, the MOSF waged all-out war to have the *Sukuk* Bill pass the National Assembly during the provisional session held in February 2010. The MOSF officials made every effort to persuade each and every member of the tax sub-committee personally, and this time, it seemed the tax sub-committee members properly understood the genuine intention of the bill.[95] Unfortunately, the February provisional session in 2010 was rather an inopportune time. It was embroiled in such a fierce political strife over the Sejong City

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[93] This opinion invited fierce criticism from the press. *See The Small-time Parliament Scuttling the Islamic Bond Act*, MK BUSINESS NEWS, Dec. 23, 2009.

[94] *See* generally the following newspaper articles, Ki-Tack Kang, *Will It Be Possible to Introduce Islam Bonds This Time?*, MONEY TODAY, February 16, 2010; Soohun Kim, *Controversies about Privileges on 'Sukuk,' the Islamic Bonds*, THE HANKYOREH, Jan. 3, 2010; Youngkyu Yoo & Minhee Kim, *Inducement of Islam Money Halted by the National Assembly*, THE SEOUL DAILY, Dec. 29, 2009.

[95] *See* generally the following newspaper editorials and articles, *The Government Expects the Provisional Session of the National Assembly in February Will Activate Sukuk*, THE EDAILY, Jan. 8, 2010); Yoomi Kim & Junehyuk Lee, *Sukuk, the Islamic Bonds, Have Become the Hot Potato of the February Session of the National Assembly*, THE KOREA ECONOMIC DAILY, Jan. 27, 2010.

Project[96] so that the *Sukuk* Bill was put in the background. Although, this time, a number of National Assembly members supported the *Sukuk* Bill, their attention was distracted by the heated controversy over the Sejong City Project. The tax sub-committee hearing was not held until late February. When it was finally held on February 23rd, the sub-committee members failed to bridge the differences among them so that the *Sukuk* Bill was not even included in the meeting's agenda.[97]

C. The Third and Fourth Attempts by the MOSF in 2010 and 2011

The *Sukuk* Bill[98] was submitted by the MOSF once more to the National Assembly during its 2010 annual regular session which started on September 1, 2010. The MOSF made a great deal of effort from the very beginning, and it seemed that the efforts were finally rewarded when the *Sukuk* Bill passed the tax sub-committee on December 3, 2010.[99] But, to many people's surprise, this decision of the tax sub-committee was overruled at the plenary session of the Strategy and Finance Committee held on December 7, 2010.[100] Mr. Sung-jo Kim, the then chief commissioner of the Strategy and Finance Committee, decided to

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[96] The Sejong City Project was a state-led project to relocate a dozen ministries and government agencies to Sejong City so as to turn the city into an administrative city. This project, which was the election pledges of President Lee Myung-bak, the then president of Korea, was still going on in 2009. On January 11, 2010, the government published a revised plan for Sejong City Project. The revised plan consisted of dropping the original plan, and proposing to instead make Sejong City a business and economic hub. This triggered a hot political controversy among politicians. *See* Chulhyun Kim, *International Science and Business Belt to be Constructed in Sejong City*, ASIA BUSINESS DAILY, Jan. 11, 2010.

[97] *See* Suck-Kee Min & Dong-Eun Kim, *National Assembly Dragging Down the 'Sukuk' Act - Securities Companies Singing the Blues*, MK BUSINESS NEWS, Feb. 23, 2010); Yoonjung Lee, *Inducement of Sukuk - Foundered After All?*, MONEY TODAY, Mar. 10, 2010.

[98] This time the *Sukuk* Bill was slightly modified but the substance of the bill remained the same.

[99] *See* Keunwoo Lee & Yongbum Park, *Islam Bonds Will Be Issued from Next Year*, MK BUSINESS NEWS, Dec. 4, 2010.

[100] The conventional rule governing the functions of the committees of the National Assembly was that the higher level committee would usually respect the decisions of the sub-committee, so that an agenda that had passed the relevant sub-committee would be adopted by the relevant committee unless a significant defect in the decision of the sub-committee was later discovered.

lay the *Sukuk* Bill on the table by virtue of his authority.[101]

The MOSF made another attempt at the February 2011 provisional session, which was held following the 2010 annual regular session, but in vain. On February 22nd, the spokesperson of the ruling party simply announced that Mr. Moo-sung Kim, the then floor leader of the ruling party, had decided at the floor council meeting held on the same day not to pursue adoption of the Islamic bonds act during the current session without giving any reasons.[102] This decision in fact dismissed the *Sukuk* Bill.

VIII. ANALYSIS OF THE PAST TAX REFORM EFFORTS AND THE WAY FORWARD

A. Reasons for Failure

The MOSF's policy to introduce *sukuk* was correct from an economic and administrative perspective, but the ministry did not appreciate the delicate nature of the potential issues (whether political or otherwise) that could arise from the introduction. In retrospect, it should have been more cautious in preparing the *Sukuk* Bill so as not to raise any potential arguments to the effect that the *Sukuk* Bill favors Islamic bonds over non-Islamic bonds. Taking appropriate precautionary measures could have prevented (or at least reduced the extent of) any hostility (whether on religious grounds or otherwise) towards the *Sukuk* Bill. Having failed to do so, the ministry should, at least, have tried harder to stop the propagation of misconception and misunderstanding in the general community about the genuine intention of, and

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[101] Mr. Sung-jo Kim later explained that despite the decision of the tax sub-committee, the overwhelming majority of the committee members expressed an opinion that this bill needed more prudent deliberation. Mr. Jeung-hyun Yoon, the then Minister of the MOSF, who was present at the plenary session of the Strategy and Finance Committee held on December 7, 2011, was so shocked at the result that he yelled out "Why?" at the plenary session when Mr. Sung-jo Kim announced the decision. *See* Yongsuk Chang, *The Amendment of STTCL Giving Tax Privileges to Islamic Bonds Fell Through*, AJU BUSINESS DAILY, Dec 7, 2010; *See also* Jongtae Chung & Shinyoung Park, *Controversy over 'Tax Exemption for Islamic Bonds' among the Government and the Ruling Party*, THE KOREA ECONOMIC DAILY, Dec. 9, 2010.

[102] *See* Byungwook Doh & Sungmin Park, *Deferring 'Sukuk Act' Again - The Ruling Party Determined Not to Discuss during This Session*, MONEY TODAY, Feb. 22, 2011.

economic rationale behind, the *Sukuk* Bill. The MOSF underestimated the influence of the Christian leaders when they first noticed the opposition movements. The failure in 2009 was crucial. With the upcoming by-election for the National Parliament scheduled in April, 2011, it was the last chance for adoption of the *Sukuk* Bill. With the election just around the corner, naturally, politicians would pay more attention to the louder voice, even if it is only from a minority.

As a matter of fact, when the *Sukuk* Bill was first submitted to the National Assembly, it did not draw much public attention and the voice against the *Sukuk* Bill was rather meek. Had the MOSF been more cautious in the first place, and made genuine efforts to persuade each member of the tax sub-committee personally at that time as done later, it is most likely that the *Sukuk* Bill would have passed the tax sub-committee in 2009 without much difficulty. The failed attempts in 2009, followed by the re-submission of the *Sukuk* Bill at the provisional session in February 2010, was not only a sensational happening, enabling the opponents to attract more public attention, but also allowed more time for building a religious coalition of opposition forces. As the time went by, the opposition from some of the Christian groups became even stronger. Most of the reasons for opposition were not rational; they were based on a misunderstanding of the legal and commercial reality of *sukuk* and the genuine intention of, and economic rationale behind, the *Sukuk* Bill. However, once public sentiment was formed, it was not easy to fight against, even if based on incorrect and misleading information.

B. Merits of the Alternative Securities Scheme

It might have taken more time, but, still, the proper strategy would have been to move in the direction of amending the Capital Markets Act pursuant to the Alternative Securities Scheme. Such strategy would most likely have worked because (i) any amendment of a sophisticated finance law such as the Capital Markets Act rarely draws much public attention, (ii) the Alternative Securities Scheme could have been implemented simply by adding a couple of provisions to the draft bill being prepared at that time (considering that the draft bill which the FSS was preparing at that time was for an overall reshuffle of the Capital Markets Act, the provisions related to the Alternative Securities Scheme would have been buried among many other

contemplated changes), (iii) the debates would have been limited to those in the related academic, industry, and market circles from which could be expected more professional and rational discussions and reactions, and (iv) the changes relating to the Alternative Securities Scheme would have been viewed as merely allowing companies to issue various alternative finance investment securities and nothing more (i.e., without arousing religious or political implications).

The Trust Act amended as of 2011 has eliminated the legal hurdles for the issuance of *sukuk* by a Korean SPV. Even without the contemplated provisions related to the Alternative Securities Scheme in the Capital Markets Act, there are currently no legal hurdles hindering the issuance of *sukuk* by a Korean SPV.[103] Still, as the Korean SPV structure involves heavy tax burdens just like the Offshore SPV structure,[104] it is not economically viable unless these tax burdens are substantially reduced. As the trust securities under the Trust Act will be issued for various purposes, it would not be desirable to grant a tax exemption for all types of trust securities but preparing another tax exemption bill, specifically aimed at trust securities issued in *sukuk* transactions, may arouse the same arguments as the previous *Sukuk* Bill. However, with the provisions on Alternative Securities in the Capital Markets Act in place, reducing tax burdens for *sukuk* can be pursued in a much subtler and more practical way as set out in section VIII.C, below. So, even with the Trust Act of 2011, it would still be recommendable to have the provisions on Alternative Securities in the Capital Markets Act.

C. Tax Reform Proposals for the Korean SPV Structure

1. Tax Burdens of a Korean SPV under the Current Tax Laws

The Korean SPV structure involves the same transaction-related taxes as in the case of the Offshore SPV structure described, in Section V.C. Also, as in the case of the Offshore SPV, the profits from *sukuk* transactions are subject to withholding taxes but there is a slight difference. As both a Korean

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[103] Lee, *supra* note 52, at 216-17.

[104] The transaction-related taxes described in Section V.C. above are also applicable to *sukuk* transactions using a Korean SPV. The profits of *sukuk* are also subject to withholding taxes, though in a different manner.

Originator and a Korean SPV are domestic companies, there will be no withholding tax at the level where the Korean Originator makes payment to the Korean SPV.[105] Instead, when payment received by the Korean SPV (i.e., the issuer) is paid to the overseas *sukuk* holders, the profits will be subject to Korean withholding taxes. As the *sukuk* issued by a Korean SPV are trust securities, the legal nature of profits on *sukuk* is profits of trust, which are classified as "interest" under the Corporate Income Tax Act for the purposes of imposing withholding taxes.[106] Payment of interest is subject to withholding tax at the rate of 20% unless otherwise reduced by the double tax treaties.[107]

In the event that the Alternative Securities Scheme is implemented in the Capital Markets Act, the Corporate Tax Income Act will need to provide how the profits of the alternative finance investment securities should be classified and taxed. Given the nature of these profits, it is likely that these will be categorized as interest subject to 20% withholding taxes unless otherwise exempted.

2. Proposal for the Tax Reform for the Onshore Structure

The lessons learned from the previous tax reform experience is that, if Korea is to have any tax reform for *sukuk*, proponents should avoid a debate over whether it is tax relief exclusively favouring Islamic bonds. Therefore, I propose to bifurcate the future tax reform efforts into (i) taking measures which will apply to the Alternative Securities in general and (ii) tax relief exclusively applicable to *sukuk* transactions, but focus only on the former for the time being.

Both the withholding taxes on profits and the transaction-related taxes are additional tax burdens on *sukuk*

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[105] In the case of *ijara sukuk* issued using an offshore SPV, the lease payment from the Korean Originator to the offshore SPV will be subject to Korean withholding taxes.

[106] Beobin saebeob [Corporate Income Tax Act], Act. No. 14386, Dec. 20, 2016 , s.93(1) (S. Kor.). If the *sukuk* holder is not a company but an individual, Income Tax Act will apply. Except the fact that the taxpayer is an individual, provisions of Income Tax Act mirror the relevant provisions in the Corporate Income Tax Act in connection with withholding taxes for payments made to non-residents. So, the discussions in this article will be limited to the provisions of the Corporate Income Tax Act.

[107] Beobin saebeob [Corporate Income Tax Act], Act. No. 14386, Dec. 20, 2016, s.98(1)(iii) (S. Kor.).

transactions compared to conventional foreign currency bonds generating Eligible Interest. However, the causes for the tax disadvantage are somewhat different. The transaction-related taxes arising from the transfer of the underlying *sukuk* assets are the burdens resulting from the unique transaction structure of *sukuk* rather than the ones caused by Korean tax policy. As relief from these taxes need to be designed exclusively for *sukuk* transactions, the purpose may be arguable, weakening the ground for the assertion that it is merely trying to level the playing field with conventional bonds.

On the other hand, unfavorable tax treatments related to the withholding tax on profits is a different story. This disadvantage is caused by the tax exemption under Section 21 of STTCA which is available only to Eligible Interest (i.e., the profits of foreign currency-denominated bonds issued by Korean companies).[108] It is relatively clear that granting a similar a tax relief to profits of *sukuk* only creates a level playing field for *sukuk* compared to conventional bonds. Hence, if we set aside transaction-related taxes for the time being and direct our efforts at providing a tax relief for withholdings only on *sukuk* profits, the legislation's chances are much better.

While it is necessary to remove both the tax on profits and transaction-related taxes to create a perfectly level playing field of the taxes involved, tax burdens caused by transaction-related taxes are rather light compared to withholding taxes on profits. Also, some of the transaction-related taxes arise only in connection with certain types of underlying assets. So long as withholding tax issues on profits are cleared, the tax burdens related to *sukuk* are not excessive. Under these circumstances, a more viable solution is to bifurcate the future tax reform efforts into a tax relief on profits and a tax relief on transaction-related taxes, and focus only on the former for the time being while setting aside the latter task until time is ripe for resuming these efforts.

If Korea pursued tax relief for profits of *sukuk* issued by a Korean SPV, there is no need to add a lengthy provision to the STTCA that is exclusively applicable to *sukuk* transactions, as was done in the previous *Sukuk* Bill for the Offshore SPV structure. Tax exemption for profits of *sukuk* issued by a Korean SPV can be

[108] Under Section 21 of the STTCA, Eligible Interest enjoying tax exemption is limited to "fees and interest on the foreign currency bonds, issued to non-residents and foreign entities outside Korea, by the Korean Government, local government entities, or a Korean Company."

achieved by simply revising the existing Section 21 of the STTCA to slightly expand the scope of Eligible Interest to include profits of *sukuk*. For this purpose, it is preferable to have the Alternative Securities Scheme in place before pursuing a STTCA revision. Currently, under the STTCA, Eligible Interest only encompasses "fees and interest on the foreign currency bonds issued by the Korean Government, local government entities, or a Korean company outside Korea, unless they are held by residents, domestic companies, and permanent establishment of foreign companies."[109] If *sukuk* are issued as Alternative Securities under the Capital Markets Act, this exemption can be extended to the profits of *sukuk* by slightly revising the current definition of Eligible Interest in Section 21 of the STTCA as "fees, interest and any other investment return in excess of the original investment amount received under the following securities issued by the Korean Government, local government entities, or a Korean company outside Korea unless they are held by residents, domestic companies, and permanent establishment of foreign companies: (a) foreign currency bonds *and (b) foreign currency alternative finance investment securities provided in the Capital Markets Act.*"

A simple revision expanding the scope of Eligible Interest in the existing provision would not draw much public attention in the first place. Further, this amendment merely contemplates extending the existing tax benefit to all foreign currency-denominated Alternative Securities. Even if the public does become aware of such attempts, this would not invoke heated debates on the issue of whether it is fair to create a special tax favor for a certain religion. The MOSF's assertion that they are merely trying to level the playing field for all financial instruments having similar economic function as conventional bonds would sound more persuasive. So, it is likely that a STTCA amendment bill widening the scope of Eligible Interest will pass the National Assembly without much debate or difficulty.

Technically, it would also be possible to extend the current exemption on the Eligible Interest to *sukuk* profits by simply revising the same Section 21 of the STTCA to cover "the profits from *sukuk"* even without the revision of the Capital Markets Act implementing Alternative Securities Scheme. There is a risk that this approach may again trigger the very debate to be avoided:

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[109] STTCA, s.21.

why, among many other financial instruments, do only *sukuk* enjoy this tax exemption? Thus, having the Alternative Securities Scheme in place before seeking the amendment of Section 21 of the STTCA would be a more practical way to seek the necessary tax reform for *sukuk*.

IX. THE CONCLUSION

In the midst of heated debates and controversies, even those holding the most extreme opposing views did not go so far as to say that Korea should not trade with Islamic countries or use Islamic funds in doing business. Rather, the sensitive issue was whether granting tax exemption exclusively to Islamic bonds was fair. Most people seem to at least agree that there is a need for Korean companies to diversify their funding sources, and, to facilitate this, attaining fuller and more direct participation in the Islamic financial market is a prerequisite. Unless economic efficiency is ensured, however, Islamic finance cannot be considered a viable and valid financing option. On that basis, efforts to remove the obstacles hindering the issuance of *sukuk* in the Korean capital markets should resume.

Regretfully, after a series of legislative defeats, the Korean government's efforts to foster favourable environments for *sukuk* issuance came to an abrupt halt. Since the revision of the Trust Act in 2011, it has become technically possible to issue *sukuk* even through a Korean SPV. However, unless necessary tax privileges are in place, it is not economically viable. Among the various tax burdens involved in *sukuk* issuance, the most critical one is the withholding taxes on the profits of *sukuk.* Unlike other taxes, this tax disadvantage is created by unequal tax treatments under Korean tax laws between the profits of foreign currency bonds and the profits of *sukuk*.[110] So, if the government focuses on providing tax relief for *sukuk* profits only, the proposed amendment could be

[110] Such discrimination is by no means intentional. The tax exemption on Eligible Interest was first introduced in 1976 as Section 15 of the Josae gamyun gujae beob [Tax Exemption and Reduction Control Act] Act. No.2785, Jan. 1, 1976 (S. Kor.). Initially, the issuers of the foreign currency bonds generating Eligible Interest were limited to financial institutions only. In 1976, the scope of eligible issuers was expanded to include domestic corporations as well. At that time, *sukuk* did not have much presence in the international market. Hence, the legislators inadvertently paid no attention to *sukuk.*

justified as seeking equal tax treatments for all securities with economic substance similar to conventional bonds. The introduction of this tax relief can be done more smoothly if the Alternative Securities Scheme is implemented in the Capital Markets Act. Despite the unfortunate tax bill detour, the time is ripe for resuming these efforts.

The introduction of *sukuk* into the Korean capital markets would mean the addition of another important tool that would facilitate Korean companies' participation and flexible operation of business in global capital markets. If tax relief for profits of *sukuk* are in place, the remaining tax burdens are not excessive, and *sukuk*, though a little more expensive than conventional bonds, can provided a real option to Korean companies who are actively seeking alternative financing.

Faced with any future financial crisis, financing at a little higher costs would still be far better than not being able to fund at all. If such hard time were to strike the Korean market again, it may also be possible for various interested parties to also agree to grant the necessary tax exemptions for transaction-related taxes, so long as it is properly presented at that time.

Therefore, the task of achieving a perfectly level playing field between *sukuk* and conventional foreign currency bonds should be set aside for the time being, and the efforts should instead be directed at providing tax relief for withholdings on *sukuk* profits only. If these efforts only resumed when another financial crisis strikes, it would likely be too late for Korean companies to avail themselves of *sukuk* – precisely when that alternative may be needed the most.

Keywords
Sukuk, Korean Capital Market, Islamic Finance, Islamic Tax Reform in Korea, Sukuk issuance by Korean companies

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