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Budget cracks down on service companies

by AJ Halkyard

Before examining what is in store for service companies, tax practitioners may find it useful to be reminded of the taxation developments arising from the 1995 Budget, delivered by the Financial Secretary on 1 March 1995. As readers will be aware, those developments were not unexpected. In summary:

1. **Tax rates.** Corporate profits tax and the standard rates remain at 16.5% and 15% respectively, personal tax allowances for salaries tax and personal assessment taxpayers have been increased generally (10%) in line with inflation, and the marginal tax bands for these taxes are unchanged. The additional dependent parent and grandparent allowances, child allowances for other than the first two children as well as the single parent allowance have been increased more significantly. A new disabled dependent allowance has been introduced. All these changes, if enacted, will take place with effect from 1 April 1994.

2. **Estate duty.** The minimum threshold for estate duty will be increased to $6 million. The top rate of duty, 18%, now cuts in where the principal value of property passing in Hong Kong exceeds $8 million. All these changes, if enacted, will take place with effect from 1 April 1994.

3. **Stamp duty.** No change, notwithstanding continued pressure by the Stock Exchange for lowering the rate of ad valorem duty on the purchase and sale of Hong Kong stock.

4. **Profits tax.** The Board of Inland Revenue will be asked to look at which items of plant and machinery fall within the three levels of annual allowance for depreciation purposes and to decide whether the current classifications, which are contained in the Inland Revenue Rules, are appropriate. Higher rates of allowances are not proposed on buildings and structures.

5. **Tax compliance.** Following a review by the IRD, it is apparent that an unacceptably high percentage of unincorporated businesses keep insufficient records to enable their taxable profits to be readily ascertained. Legislation will be proposed to specify the minimum records that a business must keep and to increase the maximum penalty for non-compliance. If this does not work, legislation to make the issue of receipts mandatory will be introduced.

'Legal loopholes'

In last year's Budget, the Financial Secretary promised a crackdown on service companies. After a year-long examination involving some consultation with legislators and practitioners, the Financial Secretary has announced that by the end of March we can expect to see legislation dealing with service companies which are, in effect, disguised employments.

In relation to the second type of perceived abuse, ie the payment of inflated management fees by a firm to a service company which is controlled by the business proprietor or by a firm's part-
ners, this will be dealt with by the issue of a Practice Note by the Commissioner of Inland Revenue. In this regard, it has been widely reported in the press and elsewhere that the permitted mark-up for a service company will be 12.5% on cost of its business-related services provided to the unincorporated business or profession. In the meantime, practitioners may wish to contemplate the consequences of a service company arrangement gone wrong: see D32/94 9 IRBRD 97 where the Board of Review was prepared to disregard completely a service company arrangement entered into by a doctor on the basis that it was artificial and fictitious (contrast D61/91 6 IRBRD 457 and D32/93 8 IRBRD 261 where only the private component attributable to the payment of the management fee was disallowed). In case the message to tax planners was not previously clear: beware!

Following the decision by Lloyds to appeal the recent judgment in Lo and Lo v World Wide Marine and Fire Insurance Co Ltd and others to the Privy Council, a senior insurance practitioner has warned that reversing the Court of Appeal could have serious implications for law firms as well as for insurers.

Between 1987 and 1989 a Lo & Lo probate clerk, Yim Chun-kui, stole money and shares belonging to the firm's clients. Yim was sentenced to 6 years imprisonment. Lo and Lo accepted responsibility, paid compensation and claimed on their insurance.

The insurers disagreed over liability. The primary insurers, World Wide Marine and Fire Insurance Company Ltd and others (who then operated the solicitors' professional indemnity insurance) claimed that their liability was limited to £4.8 million (the total sum insured in respect of any one claim) less the first £200,000 deductible under the policy. The excess insurers, Lloyds and others, argued that since the property was stolen on separate occasions the primary insurers must pay out £4.8 million for each theft.

The Court of Appeal (Civ App 1994 No 53) found for the primary insurers. A claims made policy covers the risk of claims being made during the specified period of insurance; the peril insured against is the making of the claim. There was only one claim made for restitution. The court rejected the argument that 'claim' refers to the occurrence of a state of facts which justifies a claim rather than the actual assertion of a claim. Their decision allows law firms to avoid the task of re-calculating their insurance needs.

But if the Privy Council reverses the decision, insurance costs are likely to increase, both under indemnity schemes and top-up insurance.

The outcome of the appeal to the Privy Council is unlikely to be known for more than a year. Indemnity cover provided by the primary insurers (now ESSAR) has increased to $10 million. But the current situation may prompt law firms to re-examine their provision for top-up cover.

Lo and Lo insurers appeal to Privy Council

Deacons), Michael Moser of Baker & McKenzie, Victor Chu of Victor Chu & Co, and two legal academics — Anthony Dicks and Betty Ho of the University of Hong Kong.

Demotions at Legal Department
As part of the localisation process at the Legal Department, two expatriate lawyers on the Senior Assistant Crown Prosecutor grade have been regraded to the level of Senior Crown Counsel. The expatriates lose their previous title, but retain the salary and local conditions of service commensurate with their previous rank.

Recent Eastern Express reports stated that localisation in the Legal Department is 4% over its target for 1995 except at directorate level where localisation lags 12.8% behind target. Spring Fung, Chairperson of the Local Crown Counsel Association, agreed that the senior localisation targets set by the department were not being met. 'We are not satisfied with the speed of localisation at the directorate level,' she said. A spokesman for the department said that the figures were misleading. 'We are not behind target. The actual position is that the target of 50% for directorate level is scheduled for the end of 1995'.

Spring Fung