TPM-15

Intra-group services and section 247 of the *Income Tax Act*

January 29, 2015

Legislative and policy changes
Please note that the following Transfer Pricing Memorandum, although correct at the time of issue, has not been updated to reflect subsequent legislative changes since the date of issue. As a result, some information may no longer be valid.

References and other information
This memorandum does not replace the law found in the *Income Tax Act* and its Regulations. Since this memorandum may not address your particular situation, you should refer to the *Income Tax Act*, any applicable Regulation, and relevant case law. For more information, you can contact a Canada Revenue Agency tax services office.

Introduction

1. The purpose of this memorandum is to clarify the Canada Revenue Agency's (CRA) policy on several audit and tax issues commonly encountered during the audit of intra-group services. Part 6, Intra-Group Services, of Information Circular IC87-2R, *International Transfer Pricing*, provides guidance with respect to intra-group services—this memorandum expands on the guidance discussed.

2. The content of this memorandum is arranged as follows:

- Background
- Acquiring information regarding intra-group services
- Linking services from providers to users (direct and indirect charge methods)
- Two main issues surrounding intra-group services

- First issue – Determining whether intra-group services have been provided
  - General test
  - Direct entity-to-entity services
  - Common activities undertaken for entities within the multinational enterprise group
    - Shareholder costs
    - Corporate group costs
  - Duplicate costs
  - Costs not deductible under the *Income Tax Act*
  - On call services
  - Excise tax and goods and services tax/harmonized sales tax (GST/HST) issues
- Second issue – Valuing intra-group services
- General guidelines for valuing services
- Mark-ups
  - Group service providers acting as agents
  - Pass-through costs

Background

3. Most multinational enterprises (MNEs) make a wide variety of services available to their members. The 2010 version of the Organisation for Economic Co-operation and Development (OECD*) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the *Guidelines*) uses the term **intra-group services** [1] to describe services performed for the benefit of an entity within an MNE group by either the parent company or a subsidiary within the group.

4. Intra-group services encompass a wide range of potential services in respect of many functions such as technical (e.g. engineering, legal), research and development, managerial and administrative (e.g. strategic planning, payroll accounting), financial, or other commercial services (e.g. marketing and promotion). Many enterprises use the term **management fees** to describe charges for various intra-group services between non-arm’s length parties.

5. Paragraph 7.5 of the *Guidelines*, Special Considerations for Intra-Group Services, introduces the two main issues involved in the transfer pricing analysis of intra-group services: 1) whether intra-group services have in fact been provided and 2) what amount, if any, should be charged for such services in accordance with the arm’s length principle, for tax purposes. The discussions below are presented within the context of these two issues.

Acquiring information regarding intra-group services

6. Whether the transfer pricing issue arises in the context of intra-group services or other transactions, the need for information and the tools available to auditors to acquire such information remain the same. Public documents (e.g. annual reports, website publications, Securities and Exchange Commission filings, analyst reports) may provide information about the company's critical success factors or core and non-core competencies and whether they are consistent with those described in the intra-group agreements, as well as in the transfer pricing documentation. The services charged by Canadian companies to foreign non-arm's length entities should be readily verifiable from a review of domestic records. The same should be said for incoming service fees resulting from foreign-based information. From a domestic perspective, if the taxpayer fails to meet its burden of proof that the claimed expense was incurred for the purposes of producing or gaining income, the expense will not be deductible pursuant to paragraph 18(1)(a) of the *Income Tax Act*. Concurrently, if a Canadian taxpayer is claiming a deduction that it cannot justify as having been incurred for producing or gaining income, it can expect to also have difficulty providing a justifiable explanation for transfer pricing purposes under section 247 of the *Income Tax Act*.

7. The terms or existence of a formal contract or invoicing system alone are not sufficient proof of the existence or non-existence of a service for which a charge could be justified. In some cases, auditors may be presented with contracts that claim to support the charge of**management fees** when in fact no services were provided. On the other hand, Canadian companies may be providing services to non-arm's length non-resident entities and not billing for the services provided. [2]

Relevant facts for evaluating intra-group service

8. Irrespective of the source of information, auditors should establish certain facts to properly evaluate a charge for intra-group services. The service provider and user should be identified. The rationale for the service should be explained, preferably from both the perspective of the provider and the user. In addition, the benefit to the user should be established.

9. In addition, the organizational structure and the mechanisms through which the services are provided and charged should be described. Services charged directly and indirectly should be separately identified. For allocated costs, a description of how any cost pool was accumulated and its composition is required. Any allocation keys should be described and their rationale explained. Mark-ups should be justified along with an explanation of either their presence or their absence. Auditors should also determine how

any **on-demand services** are charged and how any **pass-through costs** (from third parties or related entities) are treated in inter-company billings. Auditors should also discuss and assess any internal controls applied by the taxpayer.

Linking services from providers to users (direct and indirect charge methods)

10. Intra-group services can be charged using either the direct charge or the indirect charge method, as summarized in IC87-2R. The**direct charge method** attaches a specific charge to each identifiable service. The **indirect charge method** involves an allocation of centralized service costs to particular entities using a basis or allocation key designed to reflect the proportionate benefit received.

Direct charge method

11. The CRA has concluded that the direct charge method is preferable to the indirect charge method where it can be applied. In particular, the direct charge method should be used when:

- similar services are provided to arm's length parties; or
- the services can be reasonably identified and quantified. [3]

12. This position is consistent with the position outlined in the*Guidelines*. The OECD observes that where an MNE uses the direct charge method and charges for specific services, it facilitates the measurement of such charges against the arm's length principle because the service performed and the basis for payment are clearly identified. [4] Hence, where the conditions make it possible to apply, the direct charge method is a preferable option. In particular, where an entity within the corporate group, as a main part of its business, provides services to independent entities, the direct charge method should be used in relation to similar services provided to associated entities within the group. [5]

Indirect charge method

13. As noted above, the CRA (and the OECD) prefers the application of the direct charge method. However, it is understood that conditions favourable to its application are not always present. In such cases, IC87-2R states simply that " (…) in some situations, a service has been provided to a number of non-arm's length parties and the portion of the value of the service directly attributable to each of the parties cannot be determined. In this case the taxpayer can use the indirect charge method." [6] Whatever the form of the indirect charge or allocation, it should still reflect the arm's length principle.

14. Again, this position is consistent with the *Guidelines*, which note that in some cases the direct charge method is so difficult to apply that companies often have to resort to other options to absorb or charge centralized service costs. These alternatives can include: the incorporation of these costs into the charge for other transfers; a decision not to distribute the costs; or the adoption of an allocation method. [7] As long as the indirect charge results in an allocation that is commensurate with the expected benefit, the OECD accepts such indirect charge methods except in cases where the services are a main business activity of the provider and are also provided to third parties, in which case the direct charge method is preferable. [8]

15. The *Guidelines* also specify certain situations where an indirect charge method would likely be appropriate:

- where the direct charge method is difficult to apply because the comparative services that the entity provides to third parties are only occasional or marginal (paragraph 7.21);
- where the proportionate benefit received by each entity can only be estimated, not precisely quantified (paragraph 7.24); and
- where the analysis and record keeping required to separately track or identify the benefit received by each entity is onerous in relation to the activity itself (paragraph 7.24).

Two main issues surrounding intra-group services

Framework for analysis

16. There are two main issues of concern with respect to intra-group services: (1) determination of whether a service has actually been provided and, if so, (2) determination of an arm's length value for that service. [9] The CRA adopts this framework to evaluate transfer prices for services, as outlined in IC87-2R.

17. In establishing a framework to evaluate intra-group services, it is also useful to consider that auditors will be evaluating the charge for services from one of two possible perspectives: either where the Canadian taxpayer is paying for services it receives or where the Canadian taxpayer is charging for services it provides. While the nature of the audit focus will tend to differ depending on which of these two situations exists, the approach and principles used for evaluating intra-group services must be applied consistently and should not be influenced by the inbound or outbound nature of the charge.

First issue – Determining whether intra-group services have been provided

18. In determining whether intra-group services have been provided, it is necessary to

first identify the nature and extent of the transaction and then to perform a functional analysis of the parties involved.

General test

19. The CRA maintains that “An arm’s length entity would be willing to pay for an activity only to the extent that the activity confers on it a benefit of economic or commercial value.” [10]

20. A simple test to determine whether this objective has been met is to ask whether an independent enterprise in comparable circumstances would have either:

- paid an outside enterprise to perform the service; or
- performed the service itself.

21. If the answer to both these questions is no, a charge for the service would normally not be justified under the arm’s length principle. [11]

Direct entity-to-entity services

22. The OECD explains that services provided by one group member to one or more specific members of the corporate group that meet an identified need will generally qualify as bona fide services because the receiving entity would otherwise have had to perform the service internally or purchase it from independent parties. The repair of manufacturing equipment by a related enterprise is an example. Typically, a direct charge method would be used regarding such expenses. [12]

23. Intra-group services may be charged directly to a Canadian entity from a foreign parent or service centre. In this case, the charge should be evaluated to ensure that the Canadian entity benefitted from the service and that the service was in fact provided. The benefit should be assessed by reference to the basic test outlined in paragraph 20 above.

Direct services provided by a Canadian entity to entities in other jurisdictions (outbound charges)

24. In other cases, a Canadian entity may have provided services to a foreign entity in the corporate group. In this case, it is important to ensure that all services directly provided to the foreign entity have been accounted for and charged accordingly.

Common activities undertaken for entities within an MNE group

25. The overall CRA approach to allocating costs is:

- Shareholder (custodial) costs: No shareholder costs should be allocated to subsidiaries.
- Specific non-Canadian entity costs: None of these costs should be allocated to

Canadian entities.

- Specific Canadian entity costs: None of these costs should be allocated to non-Canadian entities.
- Corporate group (common) costs: The remaining net group costs should be allocated by means of an arm's length charge.

Shareholder and corporate group costs are discussed further below.

Shareholder costs

26. Costs that are incurred for the sole benefit of shareholders are known as custodial or shareholder costs. The *Guidelines* use the term**shareholder activity** in paragraphs 7.9 and 7.10 to describe a narrow range of activities typically undertaken by the parent company solely because of its ownership interest in its subsidiaries, i.e. in its capacity as a shareholder. [13] These activities do not warrant a charge because the other group members do not need the activity and would not be willing to pay for it if they were independent enterprises. Examples of shareholder activity costs are:

- costs of activities relating to the juridical structure of the parent itself—these include costs of issuing shares, share transfer expenses, and meetings of shareholders;
- costs relating to the reporting requirements of the parent—these include costs of consolidation of reports, maintaining shareholder records, filing of returns, and filing of a prospectus; and
- costs of managerial and control activities related to the ownership, control, and protection of the parent's assets or investments—these include legal costs, director's fees, and legal or other costs incurred in negotiating or resisting a take-over bid.

27. The CRA policy on shareholder costs is discussed in paragraphs 156 and 157 of IC87-2R. Since these costs are incurred for the benefit of the shareholders of the parent company, they should not be charged to other members of the group. The rationale is that an arm's length corporation would not bear shareholder costs of another corporation. Consequently, pursuant to the arm's length principle, a subsidiary would not bear any costs of a parent's shareholder meetings. Similarly, costs related to legal structure or general financial reporting of a particular group member should not be charged to another group member. Costs of auditing and fundraising for the acquisition of an interest would not be allowed unless the funds were raised on behalf of another member of the group to acquire a new company. In the latter circumstances, it is likely appropriate to attribute the costs to that other group member.

28. Please refer to the following income tax interpretation bulletins [14] for further information: IT-99R5, *Legal and Accounting Fees*, IT-143R3, *Meaning of Eligible Capital Expenditure*, and IT-341R4, *Expenses of Issue or Selling Shares, Units in a Trust, Interests*

in a Partnership or Syndicate and Expenses of Borrowing Money.

29. Sarbanes-Oxley costs and other similar foreign regulatory reporting requirements have become a common audit issue for shareholder/custodial costs. The disclosures required under the*Sarbanes-Oxley Act* in the United States are classified as reporting requirements of the parent company located in the United States, essential for membership on United States stock exchanges. Even though it has been established that the outlays related to these requirements are primarily directed at foreign reporting, they sometimes have an overlap with Canadian reporting requirements. Therefore, the costs associated with complying with the *Sarbanes-Oxley Act* should be reviewed and if the taxpayer can demonstrate that there is a benefit to the taxpayer associated with the charge/expense, it could be allowed as a deduction. The degree to which a benefit has been obtained or achieved by the taxpayer as a result of any allocation of costs can only be determined on a case-by-case basis.

Corporate group costs

30. For the purposes of this memorandum, corporate group costs can be defined as centralized costs of intra-group services that are not shareholder costs and that are not for services provided and charged for directly between entities. The CRA's position on allocating corporate group costs to a Canadian entity is that where the direct charge method is not applicable or cannot be employed reliably:

- the allocation must be made by means of an arm's length charge;
- the allocation should be based on a comprehensive review of the group costs carried out in advance of the allocation;
- the basis used must be explicit, definable, and available for examination by CRA auditors; and
- the allocation basis should result in costs being shared in proportion to the benefits received as stated in paragraph 168 of IC87-2R.

31. When evaluating indirect charges and cost pool allocations, it is important to evaluate the composition of the cost pool prior to considering the appropriateness of the allocation methodology. In this regard, consider the subsection of this memorandum titled "Relevant facts for evaluating intra-group services" (paragraphs 8 and 9). A review should ensure that all appropriate costs are included within the pool and inappropriate costs, such as shareholder costs or directly charged services, are excluded. Also, the cost pool should be based on actual and not budgeted costs.

32. Auditors should be aware that, when evaluating the composition of cost pools, the nature of services contained within a pool may vary so that the pools in effect are blended. Such blended pools will require more extensive analysis as the different types of services

will need to be identified and treated appropriately. A mark-up may be warranted for some services but not others, or the mark-up may vary depending on the nature of the service.

33. Where the circumstances are such that the use of an indirect charge method is warranted, the OECD provides standards that should be reflected by the method adopted by the taxpayer. The method should:

- use an allocation key that makes sense by reflecting commercial reality;
- contain safeguards against manipulation;
- follow sound accounting principles;
- result in an allocation that reflects reasonably expected benefits; and
- lead to a result that is consistent with what arm's length parties would be prepared to accept. [15]

34. For example, when evaluating salary costs related to a service, it is important to identify who performed the work, the nature of work they performed, how they were remunerated, and how their time was allocated and recorded. It is also important to review the organization chart to establish that the allocation of the individual's time was justifiable.

Selecting an allocation key

35. The CRA states, in paragraph 171 of IC87-2R, that "When choosing an allocation key (…) the taxpayer should consider the nature and use made of the service." [16]

36. Auditors should refrain from accepting the proportion of sales revenues as a single allocation basis for management fees. Sales can vary greatly from year to year, which can lead to wide fluctuations in the amount of group costs allocated when there has been little change in the benefits received. It may be preferable to implement a multiple allocation basis for intra-group services to better reflect the benefits received. It is not necessary to select a different allocation basis for each department, but a certain degree of aggregation of similar transactions may improve the reliability of the allocation. For example, time spent could be an appropriate allocation basis to allocate costs of the tax services, legal services, data processing, and the usage cost of a corporate jet, while the number of employees may be an appropriate basis on which to allocate the costs of the human resources department. In the same light, sales may be an appropriate allocation basis for advertising expenditures. The use of two or more allocation keys would reflect the diversity of the intra-group services allocated and allow for a more comprehensive matching of costs to the benefits received.

Duplicate costs

Services already performed internally or purchased elsewhere

37. According to IC87-2R, "It would be unusual for a group member to incur a charge for a service performed by another member of the group if that activity is performed by the member itself or by an arm's length party on the member's behalf." [17] Similarly, paragraph 7.11 of the *Guidelines* states that "In general no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party."

38. As indicated in paragraph 158 of IC87-2R, costs allocated to a Canadian entity in cases where the Canadian entity is self-sufficient are not allowable, but the costs of activities for which the assistance of the foreign entity is necessary or beneficial to the Canadian operations are allowable.

39. CRA policy remains that duplicate costs are not chargeable unless the taxpayer can offer a valid business reason. This valid business reason must include a functional analysis of the Canadian recipient of the service that demonstrates the Canadian entity received a benefit from the intra-group service and is supported by:

- a determination of those areas where the Canadian entity is self-sufficient; and/or
- identification of those areas where the assistance of the foreign entity is necessary or beneficial to the Canadian operations.

Multiple charges for the same service (double dipping)

40. The second category of duplicate costs, referred to as double dipping of expenses, is also a concern to the CRA. Several audit issues deal with outlays claimed as individual expenses and included again in the management fee category. Some examples are:

- Directors' fees and management fees: Auditors may encounter a situation where the Canadian entity is deducting both a management fee and a foreign director's fee at the same time. For example, a Canadian company has a foreign director who is also employed by the entity supplying the management services to the Canadian company. To ensure there is no duplication of charges for the same services under two different categories (e.g. directors' fees and management fees), the auditor's functional analysis should review in detail the services provided by the foreign directors as well as the services charged under the management fee. A thorough functional analysis of both parties to the transaction should provide details as to the duties of the foreign directors and the benefits realized by the Canadian entity from the directors' services. This will allow auditors to identify duplications in charges for services by the directors and the provider of the management services, identify the role of the foreign directors, and compare the payments to those found in arm's length situations.

- Royalty payment and management fees: Paragraph 4 of Article XII, Royalties, of the technical explanation of the Canada–United States Income Tax Convention indicates that the term **royalties**does not encompass management fees. In addition, Canadian jurisprudence confirms that the amount of royalties included in any combined management fee must be unbundled and evaluated on its own merits for deductibility and application of Part XIII tax. For example, an intra-group royalty will sometimes be charged for information technology. However, a portion of that charge may be for services related to the application of that technology. To properly evaluate this charge, the service and royalty components must be separated and analyzed individually. For more information, refer to Transfer Pricing Memorandum TPM-06, *Bundled Transactions*.
- Interest expense and management fees: Reviews of outlays labeled as management fees often disclose charges for interest embedded in the overall charge. CRA policy specifies that intra-company interest expenditures should stand alone and not be included in any collection of intra-group services claimed under the label of management fees. Interest is not a service and should not be a component of a service fee. Part XIII withholding tax may apply to an interest payment. Thus, interest can be allocated to a Canadian subsidiary but as a separate item, subject to a benefit and an arm's length test pursuant to section 247, a thin capitalization test, and evaluated pursuant to paragraph 20(1)(c) and other conditions as laid out in the *Income Tax Act*.

41. When evaluating the legitimacy of service charges, the*Guidelines* note that "The compensation for services rendered to an associated enterprise may be included in the price for other transfers. (…) In such cases, the tax administration (…) would have to check that there is no additional service fee charged and that there is no double deduction." [18] To confirm this, the *Guidelines* suggest that it would "(…) be relevant to consider the *form* that an arm's length consideration would take had the transaction occurred between independent enterprises dealing at arm's length. For example, in respect of financial services such as loans, foreign exchange and hedging, remuneration would generally be built into the spread and it would not be appropriate to expect a further service fee to be charged if such were the case." [19] In other words, when reviewing intra-group services for potential double charges, auditors should consider whether the service is one which is likely to have been charged in another form than as a service charge and, if so, auditors must check whether it has already been charged in that other form.

Costs not deductible under the *Income Tax Act*

42. Intra-group service fees may include expenses that are not deductible for tax purposes in Canada under various provisions of the*Income Tax Act*, such as paragraph 18(1)(a) which states that the expenditures must be incurred for the purpose of gaining or

producing income to be allowed as a deduction. Other provisions that restrict or disallow certain expense deductions include:

- employee stock options – paragraph 7(3)(b);
- capital expenditures – paragraph 18(1)(b);
- interest deductions – paragraphs 18(1)(b) and 20(1)(c);
- certain non-deductible reserves – paragraph 18(1)(e);
- club dues – paragraph 18(1)(l);
- charitable and political donations – paragraph 18(1)(n);
- income taxes – paragraph 18(1)(t);
- thin capitalization – subsection 18(4);
- non-deductible meals and entertainment – section 67.1;
- non-deductible illegal payments – section 67.5;
- non-deductible fines and penalties – section 67.6; and
- any accrued expense that has not met payment time limits directed by subsection 78(1).

43. A charge for management fees could include some of the non-deductible expenses listed above. In a situation where the non-resident parent company charges a lump-sum management fee to the Canadian entity without providing details as to the individual type of expenses making up the total charge, auditors should determine the arm's length amount and may need to look through the management fee to determine if the charges included are otherwise deductible for tax purposes. Whether an auditor should look through the management fee (reviewing each individual item included in the management fee) for purposes of determining non-deductible expenses is a decision that should be made on a case-by-case basis considering risk and materiality.

44. If a charge includes non-deductible items, but the amount is an arm's length amount, the *Income Tax Act* does not prevent the taxpayer from paying the amount; however, it will prevent its deduction for tax purposes. Section 247 does not inhibit the application of other sections of the *Income Tax Act* (except for those sections specifically listed in subsection 247(8)). If an arm's length amount is not otherwise deductible under the *Income Tax Act*, it does not become deductible simply because section 247 of the *Income Tax Act* and Article 9 of a tax treaty are applied. [20] While taxpayers may argue that they will be subject to double taxation on those amounts if they are not deductible in Canada, the taxpayer has no recourse under Article 9 of a tax treaty because the amounts are arm's length amounts. Unless the situation results in taxation not in accordance with other specific provisions of a tax treaty, the CRA has no power to grant a deduction since the CRA is bound by the law.

45. Where the management fee charged is an arm's length amount, and where the type of management fee contract is normally found in dealings between arm's length parties, it

may, where circumstances warrant, be acceptable not to ask for a breakdown of the items included in the management fee.

46. On the other hand, where the type of contract is not usually found in dealings between arm's length parties, auditors may look through the management fee to determine exactly what the Canadian entity is paying for. Under section 247 of the *Income Tax Act*, if an arm's length party would not pay for the transactions, there should be no reason for the charge to the Canadian entity. In addition, looking through the management fee charged may identify expenses that are not deductible under specific sections of the *Income Tax Act* or to which Part XIII withholding tax applies.

47. Where an auditor decides to look through the management fee for the purpose of determining non-deductible expenses, any resulting audit adjustments relating to specific individual items should be referenced under the appropriate sections of the *Income Tax Act*, and not simply a general reference to section 247. Adjustments under section 247 should be based on the arm's length principle and substantiated accordingly with appropriate benchmarks and comparable data.

48. Regarding the time limit for reassessing a non-deductible expense, subparagraph 152(4)(b)(iii) of the *Income Tax Act* allows an extended statute-barred period of three years past the normal reassessment period if the reassessment "is made as a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm's length." For example, an adjustment under subsection 78(1) resulting from the non-payment of a transaction is made as a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm's length and would therefore be subject to the extended statute-barred period.

On-call services

49. An issue that occasionally arises with respect to determining if a service has been provided is whether a reservation of service availability is itself a service for which a stand-by charge would be appropriate. In general, the appropriateness of such a charge should be determined by consideration of whether it would be reasonable to expect such a fee at arm's length under comparable circumstances. An example might be a retainer paid to a legal firm.
It may be helpful in making this determination to consider the extent to which the services in question have been utilized over recent years, as well as industry practice.

50. Stand-by charges for service availability would not be expected in circumstances where:

- there is little likelihood that the service will be needed;
- there is no real advantage in having the services available; and/or

- the services could likely be obtained promptly without a stand-by arrangement.

Excise tax and goods and services tax/harmonized sales tax (GST/HST) issues

Excise tax on insurance

51. A global insurance policy bought by the non-resident parent to cover the parent and the subsidiaries could be included as part of the management fees. Under Part I of the *Excise Tax Act*, a 10% excise tax may be levied on insurance premiums paid to an insurer not authorized under the laws of Canada or of any province to transact the business of insurance. [21] If applicable, auditors may review that the excise tax has been self-assessed and paid. An assessment may be raised by contacting an excise tax auditor or the related program area or the GST/HST Directorate in Headquarters.

GST/HST on imported supplies

52. Allocations of costs from a non-Canadian member of a group to a Canadian member may be considered an imported taxable supply for GST/HST purposes and, as such, may be subject to GST/HST. The Canadian member may be required to self-assess and pay GST/HST on the supply pursuant to Division IV of Part IX of the *Excise Tax Act*. Auditors may review that, if applicable, the GST/HST has been self-assessed and paid. An assessment may be raised by contacting a GST/HST auditor or the related program area of the GST/HST Directorate in Headquarters.

Differences in transfer pricing for purposes of the *Income Tax Act*and the *Excise Tax Act*

53. There are several circumstances that can lead to differences in amounts subject to GST/HST compared to amounts subject to income tax. For example, for GST/HST purposes, most transactions between related registrants are taxable on the value of the transfer assigned by the parties, whereas some supplies between non-arm’s length parties may be taxed at the fair market value of the property or service supplied, and others may be taxed as if nil consideration was provided. For purposes of the *Income Tax Act*, a recharacterization under paragraphs 247(2)(b) and (d) may therefore result in an assessment based on a different amount than that required for GST/HST purposes.

Second issue – Valuing intra-group services

54. Once the auditor has confirmed that a charge for a service is warranted because it has conferred economic or commercial value such that the receiving entity is either willing to pay for it or perform it internally, it then becomes necessary to determine the arm’s length value of the service.

General guidelines for valuing services

55. Paragraph 159 of IC87-2R outlines the context within which intra-group services should be valued. The valuation should be determined by considering the perspective of both the provider and the recipient of the service as stated in paragraph 7.29 of the *Guidelines.* The arm's length charge is not only a function of the price at which a supplier is prepared to perform the service (or the cost of providing the service) but also a function of the value to the recipient of the service.

56. The determination of an appropriate charge should take into account what an arm's length party would be willing to pay in comparable circumstances.

Mark-ups

57. In the context of valuing intra-group services, it is common to refer to mark-ups in reference to the appropriate profit element to be included in the transaction. This is likely due to the fact that the cost plus method along with the comparable uncontrolled price (CUP) method are often appropriate methods for valuing service transactions. [22] However, these are not the only methods that are appropriate for valuing services; other methods may be more appropriate depending on the circumstances. The discussion of mark-ups relating to services is simply an examination of the appropriate profit element (if any) to be recognized on these service transactions.

58. Section F of Chapter IX of the *Guidelines* provides a good example of important factors to consider when determining the most appropriate transfer pricing method to apply in evaluating a particular intra-group service transaction. The example considers an MNE that establishes a central purchasing entity to negotiate with third parties for the supply of raw materials for its manufacturing entities, a task previously performed directly by the manufacturers.

59. The *Guidelines* note that the CUP method would be most appropriate where certain conditions are present. For example, suppose the entity actually purchased and resold the raw materials to the manufacturing plants. In this case, a CUP might be available if the raw materials were available on a commodity market. Alternatively, a CUP might be provided by reference to the price previously paid by the manufacturing entities when they purchased directly from the third parties. The validity of such potential CUPs will be dependent, as always, upon their comparability to the controlled transaction in terms of the facts, circumstances, and timing.

60. If it is determined that no appropriate CUP is available, the cost plus method is recommended for consideration where a mark-up on the resale of the raw materials to the manufacturing entities can be established by reference to the mark-up earned on comparable arm's length transactions.

61. In other cases, the facts and circumstances will be such that the profit split method could be the best method to apply in order to determine how the cost savings associated with the central purchasing arrangement are most appropriately recognized and shared between the purchasing and manufacturing entities.

62. This example clearly demonstrates that, as with other types of transactions, the most appropriate method to evaluate an intra-group service will depend on the functional analysis and a careful review of the facts and circumstances surrounding the transaction.

63. The CRA's comments on mark-ups on service transactions are found in paragraphs 163 to 165 of IC87-2R. Paragraph 163 states in part that: "Arm's length service suppliers would usually expect to recover their costs plus an element of profit. However, in determining an arm's length charge for service, one must also take into account the economic alternatives available to the recipient of the service."

64. This direction is drawn from the *Guidelines* which state: "In an arm's length transaction, an independent enterprise normally would seek to charge for services in such a way as to generate profit, rather than providing the services merely at cost. The economic alternatives available to the recipient of the service also need to be taken into account in determining the arm's length charge." [23]

65. The CRA continues the direction provided in the *Guidelines* by stating: "Often, the price the recipient is willing to pay for the service does not exceed the cost of supply to the service provider. For example, in many cases, the services provided through intra-group arrangements are administrative or ancillary in nature, and the participants would only have been prepared to centralize the activity if they could share in the cost savings. Cost may represent an arm's length charge in such situations." [24]

66. It is not the administrative or ancillary nature of the services which determine that cost is often an appropriate arm's length charge in these cases. Rather, as always, it is reference to the arm's length principle and the fact that, at arm's length, the receiving entity would only have been prepared to relinquish its performance of the services if it was economically beneficial. For the recipients to share in the economic benefit of cost savings it will often be the case that such administrative and ancillary services are appropriately charged at cost.

67. This does not mean that all such services should only be charged at cost. If the taxpayer can justify a mark-up by reference to arm's length support and provide evidence that the economic benefit resulting from the centralization has been fairly recognized in the participating entities, a mark-up may be appropriate.

68. The *Guidelines* also recognize that, even at arm's length, there may be situations in which an enterprise may not realize a profit on a service transaction. For example, when

engaged in a market penetration or expansion strategy, an enterprise might temporarily charge a price for its services that is lower than the price charged for comparable services in that market. In other cases, paragraph 7.33 notes that “an independent enterprise may not realise a profit from the performance of service activities alone, for example where a supplier’s costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities.”

69. As a result, the *Guidelines* further comment in paragraphs 7.33 and 7.34, that “(…) it need not always be the case that an arm’s length price will result in a profit for an associated enterprise that is performing an intra-group service. For example, it may be the case that the market value of intra-group services is not greater than the costs incurred by the service provider. This could occur where, for example, the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the MNE group.”

70. Therefore, although an enterprise providing services at arm’s length would typically expect to generate a profit, such a profit element should not be regarded as automatic. A mark-up would not be appropriate in certain transactions as noted above.

71. Furthermore, even where a mark-up or profit element can be supported by reference to comparable transactions at arm’s length, auditors must consider whether all of that profit should be attributable to the service provider. In particular, in cases where an activity has been centralized in an MNE to generate cost savings for the participants, it is important to consider whether the participants have fairly shared in any costs savings that should accrue to them as a result of the shared service arrangement. See paragraph 9.156 of Chapter IX of the*Guidelines* for a discussion of this issue.

72. The evaluation of a mark-up or profit element is only one aspect of determining the appropriateness of a service charge. Auditors need to consider materiality when reviewing mark-ups on intra-group services. In many cases, it will be more significant to correctly establish the reference point or relevant costs upon which the mark-up or profit element will be based. The selected base must be reflective of the nature of the service function and be consistent with normal industry practice. The selected base should make sense in the context of the type of business and the facts and circumstances revealed during the functional analysis.

73. A number of other questions raised during the review may also prove to be more material. Do the services provide a benefit for the entity for which it would be willing to pay at arm’s length? Is a charge being made for a service that the entity already performs for itself or purchases from a third party? Does the service charge represent a double dip because the entity has already been charged for the activity in another expense category?

Finally, is the expense one for which a deduction is specifically disallowed under Canadian income tax rules?

Group service providers acting as agents

74. If the group service provider merely acts as an agent, [25] thereby not actually providing the services itself but facilitating the provision of the services as an intermediary, the arm's length compensation would be limited to a fee for its agency role. According to paragraph 7.36 of the *Guidelines*, "When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost-plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than would be appropriate for the performance of the services themselves."

75. This issue occurs not just with respect to the provision of services but also with respect to the acquisition of goods. Consider again the example discussed above where an MNE central purchasing entity acquires raw materials for related manufacturing entities. The service could be seen as an agency function where the purchasing entity does not take title or possession of the raw materials but simply negotiates with the third-party suppliers who continue to ship directly to the manufacturers. In such a case, it will often make more sense to relate the compensation of the purchasing entity to its costs incurred as a facilitator or to the size of the discount it obtains rather than to the value of the goods purchased. A return calculated this way will relate more directly to the agency-type function performed, either by reference to the benefits generated or the costs incurred.

76. The issue of agency functions relates to the broader question of identifying a base for calculating an appropriate fee or commission on services, or an appropriate mark-up when applying a cost plus methodology for valuing services. Careful consideration should be given to the appropriate base for calculation of such fees or mark-ups. The base should make sense in relation to the nature and quantum of the benefits provided by the service. Consider again our example of the central purchasing function. If the purchased raw material is a commodity subject to significant price fluctuation, consideration should be given to whether it would be more appropriate to calculate a return to the purchasing entity by reference to a base other than the value of the goods purchased. The concern here is that the return due to the purchasing entity might be better reflected by reference to the costs it incurs or the discounts it generates rather than to the price of the commodity which it likely does not significantly influence. In determining the most appropriate base for calculating a fee or mark-up, consideration should be given to the specific facts and

circumstances of the case as well as industry practice.

Pass-through costs

77. In some cases, an intra-group service supplier may provide some aspects of a service directly but in turn contract out other aspects of the service to third parties or internally. In such a case, part of the final intra-group service charge will be composed of indirect costs from other entities. This situation is similar to the agency issue described in the previous paragraph and the same analysis and approach should apply.

Conclusion

78. Auditors and taxpayers should be mindful of the key concerns in the audit of intra-group services: (1) determining whether intra-group services have been provided, and (2) valuing the intra-group services. It is important for all stakeholders to be familiar with the *Guidelines* and the directions issued by the CRA regarding intra-group services. In addition, all parties should bear in mind that each case rests on its individual set of facts and circumstances.

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1 Paragraph 7.1 of the *Guidelines.*

2 Paragraph 7.18 of the *Guidelines* states: “The fact that a payment was made to an associated enterprise for purported services can be useful in determining whether services were in fact provided, but the mere description of a payment as, for example, “management fees” should not be expected to be treated as prima facie evidence that such services have been rendered. At the same time, the absence of payments or contractual agreements does not automatically lead to the conclusion that no intra-group services have been rendered.”

3 Paragraph 169 of IC87-2R.

4 Paragraph 7.20 of the *Guidelines* states in part: “In certain cases, the arrangements made for the charging of intra-group services can be readily identified. These cases are where the MNE group uses a direct charge method, i.e. where the associated enterprises are charged for specific services. In general, the direct charge method is of great practical convenience to tax administrations because it allows the service performed and the basis for the payment to be clearly identified. Thus, the direct charge

method facilitates the determination of whether the charge is consistent with the arm's length principle."

5 Paragraph 7.21 of the *Guidelines* states in part that "An MNE group should often be able to adopt direct charging arrangements, particularly where services similar to those rendered to associated enterprises are also rendered to independent parties. If specific services are provided not only to associated enterprises but also to independent enterprises in a comparable manner and as a significant part of its business, it could be presumed that the MNE has the ability to demonstrate a separate basis for the charge (e.g. by recording the work done and costs expended in fulfilling its third party contracts). As a result, MNEs in such a case are encouraged to adopt the direct-charge method in relation to their transactions with associated enterprises."

6 Paragraph 170 of IC87-2R.

7 Paragraph 7.22 of the *Guidelines* states "A direct charge method for charging for intra-group services is so difficult to apply in some cases for MNE groups that such groups have developed other methods for charging for services provided by parent companies or group service centres. In these cases, the practice of MNE groups for charging for intra-group services is often to make arrangements that are either a) readily identifiable but not based on a direct-charge method; or b) not readily identifiable and either incorporated into the charge for other transfers, allocated amongst group members on some basis, or in some cases not allocated amongst group members at all."

8 Paragraph 7.21 of the *Guidelines.*

9 Paragraph 7.5 of the *Guidelines.*

10 Paragraph 154 of IC87-2R.

11 This approach is outlined in paragraph 155 of IC87-R2. It is also consistent with the position outlined in paragraph 7.6 of the *Guidelines*, part of which states: "If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle."

12 Paragraph 7.8 of the *Guidelines.*

The term **shareholder activity** should not be confused with the

13 term **stewardship activity** as used in the 1979 version of the *Guidelines* which has a different meaning. Shareholder activity describes a narrower scope of activities than did stewardship activity. See paragraph 7.9 of the current (2010) *Guidelines* for a more detailed discussion of this issue.

14 Income tax interpretation bulletins are being replaced by income tax folios. The above interpretation bulletins have not been replaced as of the date of this publication. Readers should consult the Interpretation bulletin – income tax folio table of concordance page of the CRA website for the most up-to-date information.

15 Paragraph 7.23 and 7.24 of the *Guidelines.*

16 Similarly, paragraph 7.25 of the *Guidelines* advises that "Whether the allocation method is appropriate may depend on the nature and usage of the service."

17 Paragraph 158 of IC87-2R.

18 Paragraph 7.26 of the *Guidelines.*

19 Paragraph 7.15 of the *Guidelines* (emphasis added).

20 *Utah Mines v The Queen*, 92 DTC 6194 (FCA).

21 For further details and exceptions, see the *Excise Tax Act*or CRA publication *Excise Taxes and Special Levies Memorandum x7-1, Special Levies - Insurance Premiums*,dated February 2009, located atwww.cra.gc.ca/E/pub/et/x7-1/x7-1-e.html.

22 Paragraphs 160 to 162 of IC87-2R and paragraph 7.31 of the *Guidelines*.

23 Paragraph 7.33 of the *Guidelines.*

24 Paragraph 163 of IC87-2R.

25 *Black's Law Dictionary* defines **agent** as follows: Agent: *A person authorized by another (principal) to act for or in place of him; one entrusted with another's business. […] A business representative, whose function is to bring about, modify, affect, accept performance of or terminate contractual*

obligations between principal and third persons […].

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