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Transfer pricing alert

The CRA provides additional guidance on treatment of intra-group services

February 23, 2015

The Canada Revenue Agency (CRA) has issued its 15th Transfer Pricing Memorandum (TPM), *Intra-group services and section 247 of the Income Tax Act*, which was posted on its website on February 13, 2015. TPM-15 provides clarification of the CRA's policy on several audit and tax issues commonly encountered during the audit of intra-group services and expands on the guidance provided in Part 6 (Intra-Group Services) of Information Circular 87-2R, *International Transfer Pricing* (IC87-2R).

TPMs issued by the CRA do not have the force of law in Canada. However, along with IC 87-2R, the TPMs are key documented sources of guidance to taxpayers regarding the CRA's views and administrative positions on a number of transfer pricing-related topics.

The key takeaways from TPM-15 are summarized below.

1. Intra-group services should be readily verifiable

TPM-15 notes that the need for information and the tools available to auditors to acquire such information are the same in the context of intra-group services as in other contexts. The CRA expects adequate information to verify services charged by Canadian companies to foreign non-arm's length entities (i.e., using domestic records to verify the services), as well as incoming services charged by foreign non-arm's length entities (i.e., using foreign-based information to verify the services).

TPM-15 also clearly reiterates the CRA's view that an intercompany contract/agreement and/or formal invoicing system are not sufficient evidence that a charge is justified under the arm's length principle from section 247 of the Income Tax Act.

A list of facts that should be established to evaluate an intra-group service charge is provided. Such facts include the rationale for the service from the perspective of both the service provider and the service user, clear identification of benefit to the user of the service, separate identification of direct and indirect services, information on cost pools, and allocation keys for allocated costs. Additionally, TPM-15 notes that a functional analysis of the parties involved is necessary in determining whether intra-group services have been provided.

2. Indirect charge method acceptable, but direct charge method is preferred

Consistent with the CRA's longstanding position in IC87-2R, TPM-15 reiterates the CRA's preference for the direct charge method where possible, particularly when 1) similar services are provided to arm's length parties or 2) the services can be reasonably identified and quantified.

Where the direct charge method is difficult to apply, the indirect charge method is acceptable as long as the indirect charge reflects the arm's length principle. TPM-15 notes that the indirect charge method is especially likely to be appropriate when 1) the direct method is difficult to apply because the comparative services that the entity provides to third parties are only occasional or marginal, 2) the proportionate benefit received by each entity can only be estimated and not precisely quantified, and 3) the analysis and recordkeeping required to separately track or identify the benefit received by each entity is onerous in relation to the activity itself.

3. The CRA applies a two-step framework to evaluate transfer prices

Under the framework historically adopted by the CRA and reiterated in TPM-15, the first step in evaluating transfer prices for intra-group services is to determine whether a service has actually been provided. For this determination, the test employed considers whether an independent enterprise in comparable circumstances would have either 1) paid an outside enterprise to perform the service or 2) performed the service itself. 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.

Once an intra-group service is established, the second step is to determine an arm's length value. TPM-15 notes that an appropriate service charge should take into account what an arm's length party would be willing to pay in comparable circumstances, considering both the price at which a supplier would be prepared to perform the service (or the cost of the service) as well as the value to the recipient of the service.

4. Additional guidance in respect of "shareholder" or "custodial" costs

Defining "shareholder" costs is a common challenge in transfer pricing. Consistent with existing guidance in IC87-2R, TPM-15 notes that no shareholder costs should be allocated to subsidiaries, and provides an exception from this prohibition for costs of auditing and fundraising for the acquisition of an interest by another member of the group if the funds were raised on behalf of that other group member.

Significantly, TPM-15 adds to the available guidance on shareholder/custodial costs by addressing the common audit issue relating to foreign regulatory reporting requirements such as US Sarbanes-Oxley costs. In this regard, TPM-15 notes that such costs should be reviewed given the fact that disclosures required under the Sarbanes-Oxley Act sometimes overlap with Canadian reporting requirements, indicating a potential benefit to the Canadian entity. Therefore, a charge for Sarbanes-Oxley costs could be allowed as a deduction to the Canadian taxpayer, though the CRA has cautioned that the degree to which a benefit has been obtained by the Canadian taxpayer can only be determined on a case-by-case basis.

5. Pitfalls to avoid when aggregating cost pools and choosing allocation metrics

While TPM-15 acknowledges that indirect methods such as pooling and allocating costs are acceptable, certain considerations should be kept in mind when pooling and allocating costs.

Cost pool should be based on actual and not budgeted costs

In practice, it is not entirely uncommon for taxpayers to use budgeted costs in cost-pools when calculating intercompany service charges. However, TPM-15 explicitly states that the cost pool should be based on actual and not budgeted costs. While the use of “should” rather than “must” in the guidance may indicate some room for interpretation (such as when amounts are small or budgets can reasonably be expected to mirror actual results), where practical taxpayers should consider using actual costs in cost-pools and true-up budgeted estimates with actual costs once the data is available.

Sales as allocation metric for all services

TPM-15 has formalized the CRA’s audit practice of challenging “proportion of sales” as the single allocation key used to allocate management fees/corporate group costs. Proportion of sales may be an acceptable allocation key where warranted, as TPM-15 specifically notes sales may be an appropriate allocation basis for advertising expenditures. However, the CRA will generally expect multiple allocation keys to better reflect the diversity of the intra-group services, and may perform further analysis where a single metric such as sales is used for all intra-group services.

Services embedded in other transfers charged again in service fees

TPM-15 advises CRA auditors to consider whether the service is likely to have been charged in another form already, in order to prevent “double dipping”. Examples in the TPM include directors’ fees, royalty payments and interest payments which may be embedded in a management fee.

Importance of “nature” of costs in cost pool

TPM-15 notes that CRA auditors may be expected to look through management fees in some cases. Where a CRA auditor looks through the management fee, it will involve reviewing each individual line item included in the fee to determine exactly what the Canadian entity is paying for. As this task could be onerous for both the taxpayer and the auditor, TPM-15 specifically notes that the decision to look through management fees will be made on a case by case basis, considering the need to do so based on risk and materiality.

Some taxpayers may be surprised to see the look-through rule included in the context of payments for service charges, since outside of the context of an explicit cost sharing arrangement, the charge for the service determined based on the application of the cost plus method is just what the term implies – a charge for the services rendered. The cost-based approach used to determine the arm’s length amount of the service fee should not be interpreted as a basis for characterizing the underlying cost items for the deductibility provisions of the Income Tax Act. Looking through intra-group service fees and denying a deduction in respect of certain costs incurred by the related service provider for example, but allowing the deduction in full if the same service fee were paid to an arm’s length service provider (even if the arm’s length service provider is charging a service fee to cover its non-deductible costs) may not be consistent with the arm’s length principle.

One reason noted in TPM-15 for looking through a management fee is to determine the existence of any non-deductible expenses, such as non-deductible meals and entertainment, non-deductible fines and penalties or employee stock options. TPM-15 clarifies that section 247 of the Income Tax Act does not override the application of other sections of the Act, except for those specifically listed in subsection 247(8). Therefore, if the arm's length charge is not otherwise deductible under the Income Tax Act, it would not become deductible because of section 247.

Other reasons for looking through management fees include the potential application of Part XIII withholding tax in respect of royalties and interest and the application of excise tax in situations such as the payment of certain insurance premiums and goods and services tax/harmonized sales tax in other circumstances.

TPM-15 also notes that evaluating the composition of cost pools will be relevant when various services are contained in one blended cost pool. Blended pools will require more extensive analysis, as the CRA will seek to identify and appropriately treat the different types of services according to their underlying nature. For example, a mark-up may vary depending on the service, or some services may not warrant a mark-up at all.

6. Transfer pricing methods for valuing intra-group services

The comparable uncontrolled price (CUP) method and the cost plus method are confirmed in TPM-15 as being the most appropriate methods for valuing intra-group service transactions. However, TPM-15 notes that these are not the only acceptable methods and other methods may be more appropriate depending on the circumstances.

Furthermore, TPM-15 confirms that at times the price the recipient is willing to pay for services may not exceed the cost of supply to the service provider, such as in respect of centralized administrative or ancillary services. At the same time, TPM-15 notes that administrative or ancillary services should not necessarily be charged at cost, but instead the arm's length principle should (always) be considered, and a mark-up may be justified by reference to arm's length support even in the case of administrative and ancillary services.

It is also important to note that TPM-15 acknowledges the fact that materiality should be considered when reviewing mark-ups, since in many cases it is more important to correctly establish the relevant costs upon which the mark-up or profit element will be based.

Finally, when valuing the charge when a group service provider merely acts an agent, thereby not actually providing the services but facilitating the provision of the services as an intermediary, according to TPM-15 the arm's length compensation would likely be limited to a fee for the agency role, rather than a return or mark-up for the performance of the services. The same analysis and approach for agents is advised for pass-through costs, where aspects of the service provided are contracted out to third parties or internally.

Conclusion

TPM-15 offers useful guidance in respect of intra-group services which goes well beyond previous Canadian guidance, contained primarily in IC87-2R. However, some of the most controversial audit issues, such as the look-through rule, are addressed in a manner that still leaves the taxpayers with some uncertainty. Despite not having the force of law in Canada, this TPM will nevertheless be valuable for taxpayers wishing to reduce the burden of audits by proactively designing intercompany service transaction policies and documenting such transactions in a manner consistent with CRA's expectations.

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