Canada Revenue Agency releases guidance on intra-group services and Section 247 of the Income Tax Act

Executive summary

Recently, the Canada Revenue Agency (CRA) released new transfer pricing memorandum TPM-15 (TPM), which clarifies the CRA’s policy on several audit and tax issues commonly encountered during the audit of intra-group services. The content of this TPM expands on the guidance discussed in Part 6 of Information Circular IC87-2R.

Taxpayers may need to spend additional attention and effort to ensure that their transfer pricing policies and documentation take this guidance into account and support their transactions involving intra-group services.

Detailed discussion

Recently, the CRA released its much-anticipated TPM that provides guidance on intra-group services and Section 247 of the Income Tax Act (ITA). Additional guidance in this area is helpful as CRA auditors continue to focus on management fees in their transfer pricing audits of Canadian taxpayers.

The TPM reiterates many of the points made in Information Circular IC87-2R and in the current (2010) Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines, but it also expands on these points to provide guidance to CRA auditors.

On 3 November 2014, the OECD published draft revisions to its guidance on intra-group services as part of its Base Erosion and Profit Shifting (BEPS) project. In this regard, the CRA’s decision to issue TPM-15 before the completion of the OECD consultation on...
this topic is interesting, and raises questions as to whether the CRA will modify its guidance on intra-group services once the OECD issues its final guidance.

Main issues surrounding intra-group services
The discussion in the TPM is presented within the context of two main issues involved in the transfer pricing analysis of intra-group services: (i) whether intra group services have in fact been provided, and (ii) what amount, if any, should be charged for such services in accordance with the arm’s-length principle.

The TPM explicitly states that the approach and principles used for evaluating intra-group services must be applied consistently and should not be influenced by whether the charge is inbound or outbound. It also advises taxpayers that service fees charged to Canadian companies by foreign entities should be readily verifiable from a review of foreign-based information. It is expected that CRA auditors will have access to detailed information contained in the records of the foreign entity.

Formal contracts or an invoicing system alone are not sufficient proof of the existence or non-existence of a service. The CRA expects a qualitative explanation and the rationale for the service, preferably from both the provider’s and user’s perspectives. In addition, the benefit to the user should be established.

The TPM confirms that intra-group services can be charged using either the direct charge or indirect charge method. Descriptions of the two methods are provided:

> **Direct charge**: This method attaches a specific charge to each identifiable service;

> **Indirect charge**: This method involves an allocation of centralized service costs to particular entities using a basis or allocation key designed to reflect the proportionate benefit received.

Where it can be applied, the CRA prefers the use of the direct charge method. The TPM does specify certain situations where an indirect charge method would likely be appropriate.

The TPM outlines the CRA’s overall approach to allocating costs when common activities are undertaken:

> No shareholder costs should be allocated to subsidiaries.

> Specific non-Canadian entity costs should not be allocated to Canadian entities.

> Specific Canadian entity costs should not be allocated to non-Canadian entities.

The remaining net corporate group costs should be allocated by means of an arm’s-length charge.

The TPM provides guidance and some examples of what the CRA considers to be shareholder activity costs. In a welcome development, the TPM acknowledges that certain foreign regulatory costs (e.g., Sarbanes-Oxley) incurred by a foreign parent could be allowed as a deduction if the taxpayer could demonstrate that there is a benefit to the taxpayer. On the other hand, costs of managerial and control activities related to the ownership, control and protection of the parent’s assets or investments, including directors’ fees, would be considered as shareholder activity costs and would not be allowed as a deduction.

The TPM provides a definition of “corporate group costs” along with the CRA’s position on allocating the “cost pool” to a Canadian entity. When evaluating the composition of a cost pool, the nature of services contained in the cost pool may require an extensive analysis. The cost pool should be based on actual, not budgeted, costs.

When the indirect charge method is used, the allocation key selected should consider the nature and use made of the service. The TPM provides examples of allocation keys and instructs auditors that it may be preferable to use multiple allocation keys over a single allocation key to better match the costs to the benefits received.

The TPM reinforces the CRA’s policy that duplicate costs are not deductible unless the taxpayer can establish a valid business reason. Double-dipping of expenses is a concern to the CRA as the TPM instructs auditors to check whether the cost has already been charged in another form.
Costs not deductible under the ITA

While IC 87-2R is silent on the issue of non-deductible costs being imbedded in inbound service charges, the TPM states that auditors may need to look through the service charges to determine if the charges included are otherwise deductible for tax purposes. In addition to expenses not deductible under paragraph 18(1)(a) of the ITA, the TPM provides a list of certain expenses that would be disallowed under other provisions of the ITA. The TPM advises that if an arm's-length amount is not otherwise deductible under the ITA, it does not become deductible simply because of Section 247. According to the TPM, taxpayers will be subject to double taxation on those amounts if they are not deductible in Canada under domestic provisions, as the taxpayer would have no recourse under Article 9 of a tax treaty because the amounts are arm's-length amounts. The TPM indicates that 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 ITA.

However, according to the TPM, the decision to look through the management fee for purposes of determining non-deductible expenses is a decision that the auditor needs to make on a case-by-case basis, considering risk and materiality.

CRA auditors are advised that it would be acceptable not to ask for a breakdown of the items included in the management fee if the management fee is an arm's-length amount and the type of contract is normally found in dealings between arm's-length parties. This is likely to be applied only in limited situations, with the onus being on the taxpayer.

Valuing intra-group services

The TPM contains general guidelines for valuing services and provides detailed guidance on the issue of mark-ups. Due to the fact that the cost plus method is often the most appropriate method for valuing service transactions, a discussion on mark-ups is essential. The guidance in the TPM is consistent with IC 87-2R and the OECD Guidelines of 2010. The TPM notes that mark-ups are not warranted in all situations and provides a discussion of situations where mark-ups may or may not be warranted. However, the TPM informs CRA auditors that the evaluation of a mark-up is only one aspect of determining the appropriateness of a service charge. CRA 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 relevant costs upon which the mark-up or profit element will be based. The TPM provides a number of other questions that CRA auditors should review which may prove to be more material.

Other issues

Other issues the TPM addresses include “on-call services,” “pass-through costs” and “group service providers acting as agents.” Curiously, the TPM provides specific guidance on excise tax on inbound insurance and goods and services tax/harmonized sales tax (GST/HST) on imported supplies. However, the TPM does not address other relevant issues relating to management fees such as Regulation 105 withholding considerations where payments are made to a nonresident for intra-group management services rendered in Canada.

Implications

As with other types of transactions between related parties, intra-group services need to be identified and supported by a functional analysis of the parties involved. The onus is on the taxpayer to provide proper documentation describing and supporting its position on intra-group services. In order to mitigate the risk of audit adjustments by the CRA, taxpayers need to carefully consider the level of existing documentation and the approaches used and, if necessary, improve them.

The release of this TPM is an indication that management fees continue to be a significant issue for the CRA in transfer pricing audits.
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