Insights:
Transfer Pricing

Charles River Associates

To mark up intra-group services or not, that is the question

By Brad Rolph[1]

In following the OECD [Organisation for Economic Cooperation and Development] guidelines and the provision of IC 87-2R, the CRA [Canada Revenue Agency] takes the position that a markup on administrative and technical services is generally not warranted where intra-group services are provided to members of a related corporate group by a particular member of the group, where the services are ancillary in nature to the main function of the service provider…and where the particular service provider does not provide such services to arm's length parties with a view to making a profit. This position has been consistent with previous audits where the markup on these services has been disallowed.—Canadian Revenue Agency

Like most tax authorities, the Canadian Revenue Agency routinely denies any markup applied to the cost of intra-group services deemed ancillary in nature that has been transferred to a Canadian subsidiary if the Agency deems them ancillary. However, there is no specific support for this position in Canada's transfer pricing legislation found in Section 247 of Canada's *Income Tax Act* and the Agency's interpretation of that legislation as provided in its Information Circular 87-2R (IC 87-2R), both of which endorse the arm's length principle. Paragraph 159 of IC 87-2R states that where a charge for an intra-group service is justified, the amount charged should be determined in accordance with the arm's length principle. The Agency also indicates that arm's length service suppliers would usually expect to recover their costs plus an element of profit.[2]

Based on this evidence, one would think that the Agency would allow an arm's length markup to be applied to inbound intra-group services, whether or not the service was ancillary in nature. However, according to the Agency, the price the recipient is willing to pay for a service often does not exceed the cost of rendering the service.[3] To illustrate its point, the Agency suggests "in many cases, the services provided through intra-group arrangements are administrative or ancillary in nature, and the

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[2] IC 87-2R, paragraph 163

[3] IC 87-2R, paragraph 163

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."[4]

Furthermore, according to the quote cited at the beginning of this article from an Agency assessment letter, the Agency believes the transfer pricing guidelines published by the OECD (OECD guidelines) support its position regarding markups on intra-group services. However, a careful read of paragraphs 7.33 and 7.34 of the OECD guidelines suggests otherwise. In fact, the OECD guidelines are less definitive in its guidance on the issue:

For intra-group services, the issue may arise whether it is necessary that the charge be such that it results in a profit for the service provider. 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.[5]

Although situations are cited in which "it may be" inappropriate to establish a transfer pricing policy related to intra-group services that ensures the service provider earns a profit, nowhere in the OECD guidelines is it written that in all cases a markup on ancillary intra-group services should be disallowed.[6]

Given the inconsistency between the OECD guidelines, the IC 87-2R, and the Agency's audit position, it is not surprising that foreign multinationals face significant uncertainty when addressing the issue of whether to apply a markup on the charges transferred to Canadian subsidiaries for intra-group services. This uncertainty is increasing the time it takes to complete audits and increasing the incidences in which Canadian taxpayers are forced to take their reassessments to appeals or seek relief from double taxation through competent authority. It has become a needless resource drain on both the taxpayer and the tax authorities involved.

One thing is clear. It is incumbent on the Agency to provide further guidance on this issue to reduce taxpayer uncertainty and reduce the associated administrative burden.

In the remainder of this article, I present three examples to illustrate that Canadian taxpayers still benefit from the centralization of back office ancillary services, despite the presence of a markup on allocated costs.[7] I also present one example in which no markup should be applied.

Example 1: Autonomous entities

This example is presented to rebut the Agency's premise that in many cases cost may represent an arm's length charge when the services provided through intra-group arrangements are administrative or ancillary in nature because the participants would only have been prepared to centralize the activity if they could share in the associated cost savings. This example demonstrates that sharing in the cost savings associated with centralization and applying a markup to intra-group services are two distinct issues.

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4 IC 87-2R, paragraph 163

5 OECD Guidelines, Section 7.33

6 OECD Guidelines, Section 7.34

7 This article does not address the related issue regarding the quantum of any such markup.

Consider the situation in which a Canadian taxpayer and its foreign parent are both autonomous manufacturing entities each with their own administrative back office support functions. Initially, there are no intercompany transactions between these related parties. For illustrative purposes, Table 1 presents the income statement of each company before the back office services are centralized.

Table 1: Autonomous related parties: No intercompany transactions

Income statement $millions	Foreign parent	Canadian subsidiary	Consolidated
Sales	1,000.00	100.00	1,100.00
Cost of sold good	700.00	70.00	770.00
Gross profit	300.00	30.0	330.00
Back office expenses	50.00	5.00	55.00
Other operating expenses	100.00	10.00	110.00
Total operating expenses	150.00	15.00	165.00
Operating profit	**150.00**	**15.00**	**165.00**

Note: Figures may not add due to rounding.

As shown in Table 1, the foreign parent incurs $50 million undertaking its back office activities and its Canadian subsidiary $5 million. Arguably, the costs incurred by each company to undertake their own back office support activities contribute to the overall profitability of each company. Accordingly, there is an implicit return on costs associated with these activities. Although each entity earns a net cost plus margin (i.e., operating profit/total costs) of 17.6%, the arm's length return for performing back office activities is lower than 17.6%; five percent for illustrative purposes.[8] Accordingly, the return attributable to the back office activities undertaken by the foreign parent is $2.5 million and $0.25 million for the Canadian subsidiary.

The entities then centralize their back office support activities in the foreign parent and allocate the costs incurred based on their relative share of sales.[9] If there was excess capacity in the foreign parent to absorb the work undertaken by the Canadian subsidiary without incurring more costs, centralizing the back office activities would produce $5 million of cost savings. Table 2 presents the impact that centralizing the back office services has on each entity's income statement in the absence of a markup on the intra-group services now provided by the foreign parent. As illustrated in Table 2, each entity shares proportionally in the cost savings associated with centralizing these back office support activities and, as a result, the operating profits of each entity increases.

[8] Assumes that five percent falls in the range of arm's length markups on the costs incurred by companies performing suitably comparable back office activities. My use of a five percent markup merely reflects my desire to simplify the mathematics rather than a belief that such a markup is arm's length in this circumstance.

[9] As long as the allocation of these costs is equitable, how these related parties decide to allocate these costs is irrelevant for the purposes of this example. The parties could just as easily allocate these costs based on their relative share of invoices issued.

Table 2: Autonomous related parties: Centralized intra-group services (no markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Consolidated
Sales	1,000.00	100.00	1,100.00
Cost of sold good	700.00	70.00	770.00
Gross profit	300.00	30.00	330.00
Back office expenses	45.50	4.50	50.00
Other operating expenses	100.00	10.00	110.00
Total operating expenses	145.50	14.50	160.00
Operating profit	**154.50**	**15.50**	**170.00**

Note: Figures may not add due to rounding.

However, this outcome is inconsistent with the arm's length principle. First, it is inconsistent with the premise that a service provider would expect to recover its costs plus an element of profit. Second, it is inconsistent with the premise that the party performing the functions, bearing the risks and employing the capital required, should earn the return associated with the activity.[10] Finally, as the 2010 OECD Guidelines state, determining an arm's length price for a service must be considered from the point of view of both the supplier and the recipient of the service.[11] Without applying a markup on the costs allocated to the Canadian taxpayer, the interests of the foreign parent in the context of this related party transaction have not been taken into account.

Table 3 presents the income statement of each entity after a five percent markup has been applied to the costs allocated to the Canadian subsidiary. As illustrated in Table 3, despite the markup on these ancillary, centralized services, the Canadian taxpayer still enjoys a net benefit from centralizing back office services with its parent (i.e., $0.275 million). It shares proportionally in the cost savings associated with centralization (i.e., 0.5 million) but gives up the return associated with performing the activity (i.e., $0.225 million).

[10] OECD Guidelines, Section 1.42 to 1.50

[11] OECD Guidelines, Section 7.29

Table 3: Autonomous related parties: Centralized intra-group services (five percent markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Consolidated
Sales	1,000.00	100.00	1,100.00
Cost of sold good	700.00	70.00	770.00
Gross profit	300.00	30.00	330.00
Back office expenses	45.50	4.50	50.00
Markup	-0.23	0.23	0
Operating expenses	100.00	10.00	110.00
Total operating expenses	145.27	14.73	160.00
Operating profit	**154.73**	**15.27**	**170.00**

Note: Figures may not add due to rounding.

This example demonstrates that adhering to the arm's length principle and applying a markup on allocated costs resulting from centralizing back office activities is not inconsistent with the Canadian taxpayer benefiting from the cost savings associated with centralization.

When the foreign parent is a manufacturer

Before proceeding to the second example in which a markup on costs should be applied, a potential counter argument that has been raised by the Agency should be addressed. Notwithstanding the example described above, the Agency has also disallowed the markup on allocated costs associated with intra-group back office support services in situations in which providing these back office support services activities is not the primary function of the foreign related party.

This counter argument is inconsistent with the arm's length principle. Whether these back office support services are provided from within a manufacturing entity as described above or from within a separate related party whose principal activity is the provision of back office services should not matter. What matters is that the entity performing the function, bearing the risks and employing the capital, realizes the return on costs associated with that activity, implicit or otherwise.

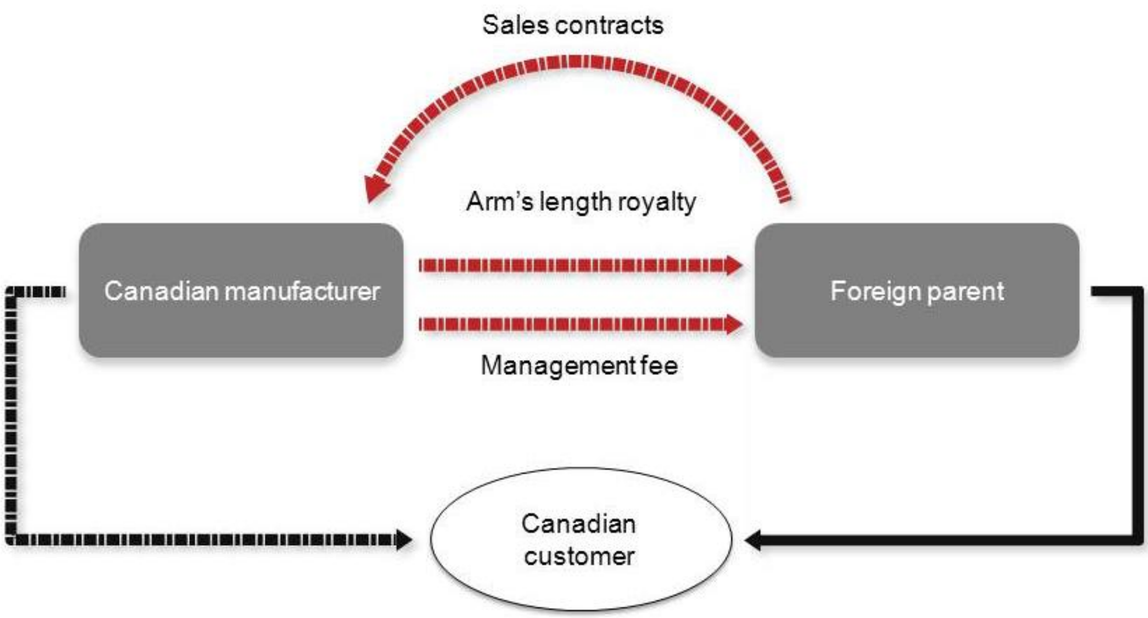
Example 2: Centralizing services—dual entrepreneurs

In the first example, the parties involved were initially autonomous. In this second example, the Canadian taxpayer does not exist at the outset. This example demonstrates that it is important to understand the transaction flow and where the returns are being realized before determining whether a markup should be applied on the costs incurred providing intra-group services.

In this scenario, the foreign parent has historically manufactured and sold parts to a Canadian customer. The foreign parent performed all functions of an administrative nature. Again, the costs incurred undertaking these back office support services contributed to the overall profitability of the foreign parent implying that the foreign parent realized an implicit return on these costs.

To meet a customer's needs, the foreign parent establishes a Canadian facility to manufacture and sell products to the Canadian customer as depicted by the broken lines in Exhibit 1.[12] The foreign parent continues to perform all functions of an administrative nature related to the Canadian manufacturing facility, for example, payroll, invoicing, collecting receivables, human resources, and information technology services. For business reasons, the foreign parent has chosen to treat the Canadian subsidiary as if it was an entrepreneur—the Canadian subsidiary buys the Canadian business from the foreign parent, licenses the necessary technology from the foreign parent, and retains the foreign parent to undertake specific back office support functions. As illustrated in Exhibit 1, an arm's length royalty for the use of technology is put in place based on a comparable uncontrolled transaction. A management fee for the provision of these intra-group services is also put in place.

Exhibit 1



In this situation, given that the Canadian taxpayer is the seller of record to the ultimate customer, Exhibit 1 illustrates that in the absence of a markup on the costs incurred by the foreign parent to undertake these back office functions, the Canadian taxpayer would realize the return on costs attributed to these functions. To see this, note that the return on cost attributed to the back office activities performed by the foreign parent prior to the existence of the Canadian taxpayer is only realized if a markup is applied to the management fee.

Example 3: Centralizing services—distributor

This third example demonstrates that a markup on intra-group services should be applied when the foreign subsidiary is a distributor. Table 4 presents the income statement of each entity before the back office support services have been centralized. As in the first example, the foreign parent incurs $50 million in back office support services and the Canadian subsidiary $5 million. Because they perform the function, the back office activities contribute to their overall profitability—$2.5 million for

[12] It is assumed that the contract has been legally assigned and the foreign parent duly compensated.

the foreign parent and $0.25 million for the Canadian subsidiary, assuming a five percent return on costs.

Table 4: Foreign parent and related distribution subsidiary: No centralized intra-group services

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,082.00	100.00	-82.00	1,100.00
Cost of sold good	770.00	82.00	-82.00	770.00
Gross profit	312.00	18.00		330.00
Back office expenses	50.00	5.00		55.00
Operating expenses	100.00	10.00		110.00
Total operating expenses	150.00	15.00		165.00
Operating profit	**162.00**	**3.00**		**165.00**

Note: Figures may not add due to rounding.

The entities then agree to centralize their back office activities in the foreign parent and allocate the costs incurred based on their relative share of third-party sales. Continue to assume that the cost savings are $5 million. Table 5 presents the impact of this centralization initiative on each company's income statement in the absence of a markup on the intra-group services provided by the foreign parent. As illustrated in Table 5, each entity shares proportionally in the cost savings associated with centralizing the back office services and, as a result, the operating profits of each entity increases.

Table 5: Foreign parent and related distribution subsidiary: Centralized intra-group services (no markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,082.00	100.00	-82.00	1,100.00
Cost of sold good	770.00	82.00	-82.00	770.00
Gross profit	312.00	18.00		330.00
Back office expenses	45.50	4.50		50.00
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.50	14.50		160.00
Operating profit	**166.50**	**3.50**		**170.00**

Note: Figures may not add due to rounding.

However, this outcome is inconsistent with the arm's length principle; in the absence of a markup, the foreign parent has performed the activity but the return associated with the function has been captured by the Canadian subsidiary.

Table 6 presents the income statements of each entity assuming a markup of five percent has been applied to the costs allocated to the Canadian subsidiary. As illustrated in Table 3, the Canadian taxpayer still benefits from centralizing back office support services, despite the presence of the markup.

Table 6: Foreign parent and related distribution subsidiary: Centralized intra-group services (five percent markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,082.00	100.00	-82.00	1,100.00
Cost of sold good	770.00	82.00	-82.00	770.00
Gross profit	312.00	18.00		330.00
Back office expenses	45.50	4.50		50.00
Markup	-0.23	0.23		0
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.27	14.73		160.00
Operating profit	**166.73**	**3.27**		**170.00**

Note: Figures may not add due to rounding.

Table 7 presents the outcome if the related parties recalibrate the transfer price for products purchased by the Canadian distributor from the foreign parent such that the distribution entity realizes the median return of the comparables. As shown in Table 7, the Canadian subsidiary no longer benefits from the centralization initiative; all of the cost savings from the centralization of back office support services is realized by the foreign parent. Such a result would not be arm's length. Consequently, taxpayers need to be mindful that they do not erode the benefits realized by subsidiaries from centralizing back office expenses particularly if they rely on the comparable profits method or the transactional net margin method to set their transfer prices for product sold in such situations.

Table 7: Foreign parent and related distribution subsidiary: Centralized intra-group services (five percent markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,082.27	100.00	-82.27	1,100.00
Cost of sold good	770.00	82.27	-82.27	770.00
Gross profit	312.27	17.73		330.00
Back office expenses	45.50	4.50		50.00
Markup	-0.23	0.23		0
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.27	14.73		160.00
Operating profit	**167.00**	**3.00**		**170.00**

Note: Figures may not add due to rounding.

Example 4: Centralizing services—contract manufacturer

The final example describes a situation in which a markup on the intra-group services provided by a foreign parent should not be applied. In this scenario, the Canadian taxpayer and the foreign parent are both manufacturing entities each with their own administrative back office support for human resources and information technology. In this scenario, the entities are not autonomous manufacturing entities but rather the Canadian subsidiary is a contract manufacturer for the foreign parent. For illustrative purposes, assume that the transfer price associated with the products sold by the Canadian subsidiary to its foreign parent is based on its total operating costs, including cost of goods sold, selling, general and administrative expenses, and depreciation, plus a markup of eight percent. Again, the costs incurred undertaking these back office activities contribute to the overall profitability of each company. For illustrative purposes, Table 8 presents the financial position of each company.

Table 8: Foreign parent and related contract manufacturing subsidiary: No centralized intra-group services (five percent markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,100.00	91.80	-91.80	1,100.00
Cost of sold good	791.80	70.00	-91.80	770.00
Gross profit	308.20	21.80		330.00
Back office expenses	50.00	5.00		55.00
Operating expenses	100.00	10.00		110.00
Total operating expenses	150.00	15.00		165.00
Operating profit	**158.20**	**6.80**		**165.00**

Note: Figures may not add due to rounding.

Assume that the foreign parent incurs $50 million undertaking these human resource and information technology activities and Canada $5 million. The entities then agree to centralize these activities in the foreign parent and allocate the costs incurred based on their relative share of employees and information technology users; Canada's relative share is nine percent. Assume that centralizing these activities eliminates the $5 million of costs incurred by the Canadian taxpayer. As a result, the total costs incurred by the foreign parent and Canadian subsidiary are $50 million. If Canada's relative share of the back office costs is nine percent then it should incur $4.5 million in expenses.

Table 9 presents the impact of this centralization initiative on each company in the absence of a markup on the intra-group services provided by the foreign parent. As illustrated in Table 9, each entity shares in the cost savings associated with centralizing these activities and, as a result, the operating profits of each entity increases.

Table 9: Foreign parent and related contract manufacturing subsidiary: Centralized intra-group services (no markup)

Income statement $millions				
	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,100.00	91.80	-91.80	1,100.00
Cost of sold good	791.80	70.00	-91.80	770.00
Gross profit	308.20	21.80		330.00
Back office expenses	45.50	4.50		50.00
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.50	14.50		160.00
Operating profit	**162.70**	**7.30**		**170.00**

Note: Figures may not add due to rounding.

However, this outcome is inconsistent with the arm's length principle. The foreign parent is now performing back office functions for another party and not receiving any profit for doing so. The returns that should be earned by the foreign parent have been captured by the Canadian subsidiary. As a result, the Canadian contract manufacturer is now realizing a return on its costs of 8.6%.

Simply adding a markup to the costs incurred by the foreign parent providing these back office services to the Canadian contract manufacturer is also insufficient to achieve an arm's length result. Table 10 presents the income statements of each entity assuming a markup of five percent has been applied to the costs allocated to the Canadian subsidiary. Based on the financial data in Table 10, the Canadian subsidiary now realizes a return on its costs of 8.4% [i.e., 7.08/(70.00 + 4.50 + 0.23 + 10)], still higher than the return on costs it has realized prior to the centralization of back office services.

Table 10: Foreign parent and related contract manufacturing subsidiary: Centralized intra-group services (five percent markup)

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,100.00	91.80	-91.80	1,100.00
Cost of sold good	791.80	70.00	-91.80	770.00
Gross profit	308.20	21.80		330.00
Back office expenses	45.50	4.50		50.00
Markup	-0.23	0.23		0
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.22	14.73		160.00
Operating profit	**162.92**	**7.08**		**170.00**

Note: Figures may not add due to rounding.

Ultimately, the Canadian subsidiary is a contract manufacturer and should not benefit from centralizing back office services with its foreign parent given that the price of the products it sells to its foreign parent is based on its costs. To see this, first consider the outcome of marking up the costs allocated to the Canadian contract manufacturer by five percent and recalibrating the transfer price of the products it sells so that it realizes a return on costs of eight percent. As illustrated in Table 11, this approach leads to the perverse result that the Canadian contract manufacturer earns a profit on the markup added to the costs allocated to it by its foreign parent because the markup is in the cost base used to determine the transfer price for products sold between the foreign parent and the Canadian subsidiary.

Table 11: Foreign parent and related contract manufacturing subsidiary: Centralized intra-group services (five percent markup, cost plus eight percent)

Income statement $millions	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,100.00	91.50	-91.50	1,100.00
Cost of sold good	791.50	70.00	-91.50	770.00
Gross profit	308.20	21.50		330.00
Back office expenses	45.50	4.50		50.00
Markup	-0.23	0.23		0
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.22	14.73		160.00
Operating profit	**163.22**	**6.78**		**170.00**

Note: Figures may not add due to rounding.

Now consider the outcome when no markup is applied to the costs allocated by the foreign parent and the transfer price of the products it sells is recalibrated so that it realizes a return on costs of eight percent. As illustrated in Table 12, this approach leaves the Canadian contract manufacturer with $0.04 million less profit than it had realized before the centralization of back office services occurred. This amount is equal to the amount of cost savings realized by the Canadian contract manufacturer ($0.5 million) times the target return on costs (eight percent). This is an arm's length result under the circumstances. Each entity earns an arm's length return for the activity that it performs.

Table 12: Foreign parent and related contract manufacturing subsidiary: Centralized intra-group services (no markup, cost plus eight percent)

Income statement $millions				
	Foreign parent	Canadian subsidiary	Eliminations on consolidation	Consolidated
Sales	1,100.00	91.26	-91.26	1,100.00
Cost of sold good	791.26	70.00	-91.26	770.00
Gross profit	308.74	21.26		330.00
Back office expenses	45.50	4.50		50.00
Markup	0.00	0.00		0
Operating expenses	100.00	10.00		110.00
Total operating expenses	145.50	14.50		160.00
Operating profit	**163.24**	**6.76**		**170.00**

Note: Figures may not add due to rounding.

Conclusion

Foreign taxpayers face significant uncertainty determining whether to mark up costs charged for intra-group services provided by the foreign entity. This article demonstrates that the Agency's administrative policy of disallowing this markup regardless of the situation is not always consistent with the arm's length principle. Marking up the costs of intra-group services is not incompatible with Canadian subsidiaries benefiting from centralized services.

Continuing this administrative policy blindly has dire consequences for Canadian taxpayers and the Agency. Clearly, the time and money wasted by taxpayers defending a position that they should not have to defend could be invested more wisely. Such investments would certainly do more to enhance Canada's economy than the potential tax revenue raised by aggressively auditing markups on management fee, particularly given the resource constraints faced by the Agency.

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