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Fees That Hold

The four tests an intercompany service charge has to pass, and why the benefit test defeats more management fees than the mark-up ever does.

Management fees and intercompany services: charge, support, defend

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A management fee between group companies is deductible where a real service was provided, the recipient obtained a benefit, the cost base is right and the mark-up is arm's length. Most disallowed fees fail on the second test, not the fourth.

Who this is for

- Groups charging a head office or shared services fee across a border.
- Finance teams whose management fee has been questioned in an audit or a review.
- Owners of a parent company that carries costs its subsidiaries benefit from.

Four tests, in the order an auditor applies them

First: was a service actually rendered? Something identifiable must have been done, by identifiable people, in a period that matches the charge. Second: did the recipient obtain a benefit it would have paid an independent party for, or performed itself? Third: is the cost base correct, containing only the costs of providing that service? Fourth: is the mark-up on that cost base arm's length?

Groups spend most of their documentation effort on the fourth test and lose on the second. A charge for services the subsidiary neither needed nor used is not saved by an impeccable benchmarking study on the mark-up.

The benefit test, and the four things it excludes

The benefit test asks a simple counterfactual: would an independent company in the recipient's position have paid for this, or done it itself? If the answer is no, the charge is not deductible however it was computed.

Four categories are routinely excluded. Shareholder activities — costs the parent incurs because it is an owner, such as preparing consolidated accounts, holding shareholder meetings, or complying with the parent's own reporting requirements — benefit the shareholder, not the subsidiary. Duplicative services the subsidiary already performs for itself. Incidental benefits that arise simply from being part of a group, such as improved creditworthiness by association. And costs relating to an activity the subsidiary has no interest in at all.

The practical consequence is that the cost base has to be scrubbed before it is allocated, and the scrubbing has to be documented. Our page on themanagement fee studysets out how the exclusions are evidenced.

Evidence is contemporaneous or it is argument

The evidence that carries weight is the evidence created while the service was being performed: time records or activity logs, email and document trails, meeting notes, deliverables, and the internal request that prompted the work. A memorandum written two years later describing what was probably done is not the same thing and is not treated as the same thing.

This is a system design problem more than a tax problem. Groups that decide once how service requests are logged and how time is captured produce a defensible file every year at almost no marginal cost. Groups that do not are reconstructing history each time.

The mark-up, and the withholding question underneath it

A mark-up on the cost of providing routine support services is normal and expected; the level is established by benchmarking comparable independent service providers. Some jurisdictions offer a simplified approach for low value-adding services with a set mark-up and lighter documentation, which is often the proportionate answer for a small group.

Underneath the deduction question sits a withholding question that is easy to miss. Depending on the character of the payment and the treaty, a cross-border service fee may attract withholding in the paying country — particularly where it could be characterised as a fee for technical services or a royalty rather than a plain service fee. The characterisation is driven by what is actually provided, which is another reason the description matters.

Setting up a defensible service charge

Do this once properly and it becomes an annual update rather than an annual argument.

1. **List the services actually provided** By service line, with the people who perform them and the entities that receive them. Anything nobody can name is not a service.
2. **Scrub the cost base** Remove shareholder activities, duplicative services and costs unrelated to the recipients. Document what was removed and why — that record is what answers the benefit test.
3. **Choose direct charging where possible** Identifiable services to identifiable recipients get billed directly. Only genuinely group-wide services go into an allocation pool.
4. **Select an allocation key and justify it** The key should relate to the benefit received, be measurable from records you keep, and stay consistent between years.
5. **Set the mark-up on evidence** Benchmark comparable independent providers, or use a jurisdiction's simplified approach for low value-adding services where the group qualifies.
6. **Paper it and check withholding** A service agreement describing what is provided, invoices that match it, and a check on whether the payment attracts withholding under the applicable treaty.

Papers to gather

What a management fee file contains:

- Intercompany services agreement, with a schedule of services by line.
- The cost base build-up, showing what was included, excluded and why.
- The allocation key, its source data, and the calculation for each recipient.
- Benchmarking evidence for the mark-up, or the basis for a simplified approach.
- Contemporaneous evidence of delivery: time records, deliverables, meeting notes, request logs.
- Invoices matching the agreement and the calculation.
- A note of the withholding analysis and any treaty declaration lodged with the payer.
- The prior year's file, so the year-on-year consistency is visible.

Where it goes wrong

- **Charging a percentage of revenue with no cost base** It has no answer to the benefit test and no cost to support the mark-up. It is the single most commonly adjusted intercompany charge.
- **Leaving shareholder costs in the pool** Consolidated reporting, parent-level audit and investor relations benefit the shareholder. Allocating them to subsidiaries invites disallowance of the whole charge, not just that slice.
- **Documenting delivery after the audit letter arrives** Contemporaneous evidence is qualitatively different from a later reconstruction. The cheapest fix is a logging habit, put in place now for next year.

Questions this raises

Can the parent charge a management fee with no written agreement?

It can invoice, but the deduction is much harder to sustain. Without an agreement the auditor characterises the payment, and an unsupported charge to a related non-resident is an easy adjustment. The agreement should also describe what is genuinely provided.

What mark-up is acceptable on intercompany services?

The one the evidence supports for comparable independent providers of that service. Several jurisdictions also offer a simplified approach for low value-adding services with a prescribed mark-up and reduced documentation, which is often proportionate for a smaller group.

Is a management fee subject to withholding tax?

It can be, depending on the paying country and how the payment is characterised. A plain service fee, a fee for technical services and a royalty are treated differently, and the characterisation follows what is actually provided rather than the invoice wording.

Our subsidiary is loss-making. Can we still charge it?

Yes, if a real service was provided and the recipient obtained a benefit. Profitability is not the test. But a charge that pushes a subsidiary into loss will attract attention, so the benefit evidence needs to be stronger, not weaker.

What to do next

If a fee is already being charged, the highest-value review is a benefit test and cost base scrub on last year's charge — it usually finds both an exposure and an under-charge. If a fee is about to start, set the agreement, the cost base and the evidence routine before the first invoice.

We prepare management fee studies, the supporting agreements and the withholding analysis as one fixed-fee engagement agreed before work starts. See intercompany agreements and cost sharing between group companies.

Legal Quotient Consultants

Cross-border and international tax. Fixed fees agreed in writing before work starts, quoted from your own documents.

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