MANAGING A TRANSFER PRICING EXAM? WASH YOUR HANDS WITH SOAP AND WATER

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Tags Audit I.D.R. Transfer Pricing The arrival of an information document request ("I.D.R.") for transfer pricing documentation often comes as a surprise to a company. Typically, two or three years have passed since the year under examination and little is recalled about transactions reported on a Form 5472, which reports transactions with controlled taxpayers such as a foreign parent or a related supplier outside the U.S. Yet, in today's post-B.E.P.S. world, international examinations with a focus on transfer pricing are commonplace.

The I.R.S. transfer pricing exam process and resource infrastructure was built for large multinational companies that participate in most of the controlled transactions that cross borders. A considerable amount of information is needed by a taxpayer in order to select and apply a specified or unspecified transfer pricing method and to explain the associated assumptions and conclusions.

Bob Rinninsland and I discussed the implications of the I.R.S. Transfer Pricing Roadmap¹ and the Quality Examination Process² in a 2014 issue of *Insights*.³ At that time, Bob predicted a more fact-driven audit process would become the norm, with less immediate focus being placed on the selection and application of a transfer pricing method. Amid the turmoil of the B.E.P.S. Project, I thought that the O.E.C.D. approach – in which a transfer pricing theory goes searching for facts – might become more commonplace among tax examiners.

While the I.R.S. is moving in the direction that Bob expected, some old habits of tax administrations, companies and their tax executives, and advisors have not changed. Transfer pricing exams are not like dual-authored articles in a tax journal. Neither side is satisfied with being partially correct at the end of a transfer pricing exam.

In an attempt to avoid negative results from the taxpayer side or the examination team side, each may engage in behavior reflecting cognitive bias and other influences.⁴ These biases and behaviors often result in conflict between the participants in the examination process. Economists understand that the outcome of a transfer pricing dispute is as much a function of the behaviors and interactions of the taxpayer and the examination team as the strength of the technical arguments concerning

Transfer Pricing Audit Roadmap, (February 2014).

Achieving Quality Examinations through Effective Planning, Execution and Resolution, Pub. 04837 (Rev. November 2010).

³ "I.R.S. vs. O.E.C.D. – How Are Tax Authorities Planning to Conduct Your Next Transfer Pricing Audit," *Insights* 2 (2014).

We refer to the principles of psychology imported into the economics discipline most notably by Daniel Kahneman and Amos Tversky in the 1970's through the 1990's. The field is known today as behavioral economics.

comparability and assumption reliability that underlie the company's position and that of the examination team.

Transfer pricing exams and dispute resolution is a vast topic. I will focus on three aspects of transfer pricing exams where trouble typically arises. These are

- various forms and sources of cognitive bias,
- neglect of the regulations in favor of adopted heuristics, and
- inadequacies in documentation and *ex ante* analysis of several types.

COGNITIVE BIAS

Several types of cognitive bias frustrate the review of the application of the best method rule,⁵ and create impasses to managing the effects of contrary positions held by the I.R.S. and companies.

Before an exam starts, the objectives of the players involved are reasonably clear. Companies want the I.R.S. to review their materials and understand and "buy into" each pricing position, so that field work may be concluded quickly with no income adjustment and no double taxation. The I.R.S. wants to verify that the facts in the company's transfer pricing documentation are true, test the major assumptions contributing to the pricing positions, and check and understand the data employed and calculations performed either in the transfer pricing documentation or by the company as it determines transaction values during a tax year.

Advisors expect that the position they have determined to be sustainable will be challenged by the I.R.S. but is highly likely to hold. Furthermore, they assume management of the company will share its viewpoint.

Contradictory and undiscovered facts, a contrarian position on method or analysis adopted by the I.R.S., or an income adjustment may cause companies to view their original position with some bias. New evidence that emerges from I.R.S. I.D.R.'s, meetings, and key executive interviews is often rejected by companies and advisors, as this evidence destabilizes the original position.

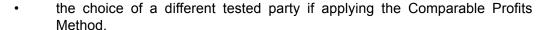
This bias against new information without an objective reason is called the Semmelweis Reflex after the rejection by the colleagues of Dr. Ignaz Semmelweis of his suggestion of adopting the practice of handwashing between medical procedures. Semmelweis was eventually proved right, but not before his peers chose to uphold the then-popular belief that gentlemen's hands do not transmit contaminants or disease.

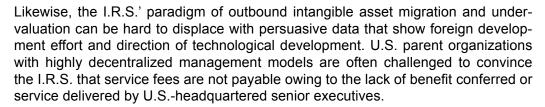
Examples are

- a tendency to reject an I.R.S. challenge of a stylized business model like "limited-risk distribution" or "contract service provider,"
- the discovery of authority to bind a foreign seller in a contract where this authority was posited not to exist,

⁵ Treas. Reg. §1.482-1(d).







Companies and the I.R.S. can succumb to the Semmelweis Reflex because of widely-held beliefs. These beliefs can result from groupthink and the negative effects of diverging from common practice given a different fact pattern or new data becoming available. This tendency to take positions that have been adopted in previous cases by industry or I.R.S. peers or colleagues, can lead to entrenched positions and all-out defenses of positions for the sole reason that their adoption did not cause the investigator to stand out from a large or influential group of adopters. Taxpayer advisors can suffer from the same bandwagon bias, too.

The intent of transacting parties matters when characterizing a transaction, selecting a transfer pricing method, or assessing comparability. Outcome bias appears when a decision made at the beginning of a series of transactions is judged by the outcome of this decision (usually measured in terms of profitability) rather than the quality of the decision at the time it was made. This cognitive bias lies at the core of the I.R.S.' position on cost sharing and the commensurate with income standard.

Finding comparable data is not easy. Profit-based analysis using databases is a workable alternative to often elusive private company and transaction data. To apply the best method rule, all data and all methods must be considered and evaluated. The "law of the instrument" bias creeps in when the analyst instinctively assumes the comparable profits method ("C.P.M.") is the best method. The C.P.M. is widely used today to the point of over-reliance by less skilled analysts. This has the effect of ignoring or undervaluing alternative methods that may be good best-method candidates and leaving a position open to attack on examination. The old adage "if all you have is a hammer, everything looks like a nail" is one to keep in mind when selecting the best method.

If it is well known that finding comparable data is not easy, analysts and international tax planners may make recommendations of a best method under the influence of the well-travelled road effect. If it is believed that profit-based methods or other heuristics (the well-traveled road) always take less time and effort to determine, this may lead to the underestimation of the effort needed to apply these methods and the overestimation of the effort needed to apply alternative methods. This can lead to faulty best method conclusions and surprises on examination and during M&A deals when the well-traveled road suddenly collapses.

Lastly, one of my favorite transfer pricing cognitive slips is made when a transaction participant is described as having limited risk by virtue of the fixed-profit transfer pricing outcome that has been imposed. This is surrogation, which occurs when the analyst loses sight of the strategic construct – in this case, the risk borne by a company that participates in a controlled transaction. As a result, a profit level indicator



("P.L.I.") that is intended to represent a construct, itself, becomes the construct.6

TRANSFER PRICING HEURISTICS

Heuristics serve as "broad rules of thumb" and can be found to influence a company or the I.R.S.' position. A simple question replaces a more difficult question, and to the delight of the investigator, a simple answer is found. The trouble with the use of heuristics is that complex or unclear fact patterns make them unreliable. Have you ever wondered why you keep hearing any of the following transfer pricing chestnuts?

- Distributors earn an operating margin between two and five percent.
- Mark-ups seem to rise in increments of five percentage points.
- Selections of the tested party are all about being the "simplest" of two or more controlled taxpayers.
- An even 50/50 split of gross or residual profit is often the first guess.

An objective and thorough best method analysis may suggest that none of these heuristics should be used but the availability heuristic – an estimate based on what is more available in memory is difficult to work past, especially if vivid or emotionally charged examples come to mind. Spotting over-reliance on a heuristic early in the exam process can help to lead any controversy to the heart of the matter, push past entrenched positions using an objective application of the regulations, and reduce time and expense.

It is not uncommon to hear companies, their advisors, and tax authorities remark that a particular circumstance has been encountered before or looks familiar. Most people call this cumulative prior knowledge experience, but this information can also accumulate in a way that biases the judgement of an individual examining a transfer pricing position in the current period. Different from advising on a current matter using prior regulations as guidance, the representativeness heuristic can be unknowingly put to use here by judging the likelihood of the success of a transfer pricing position under exam on the basis of simple resemblance. We also know that matters can have different outcomes based on the examiner and the effects of personal interaction between the company and the I.R.S., but the temptation to judge a book by its cover can sometimes be strong and should be avoided.

It takes some discipline, professional skepticism and experience to recognize and work to mitigate the effects of cognitive bias. Awareness of the possible presence of various forms of cognitive bias is a positive first step.

DOCUMENTATION DISAPPOINTMENTS

Documentation prepared pursuant to Treas. Reg. §1.6662-6(d) serves as a company's chance to make a good first impression on the examiner, and to begin making the case for its position. As all positions are connected with a transaction or a series of transactions, and all methods should be applied at the transaction level to achieve the most reliable measure of an arm's length result, it follows that the explanation of the context and attributes of the transaction, and the functions and

⁶ Treas. Reg. §1.482-1(d)(3)(iii)(B)(3).

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risks inherent in the transaction should focus on the transaction. This is often not the case, and confusion arises as a result of written explanations of the broader business of the legal entity and the too-generalized characteristics and attributes of the broad industry classification. Similarly, inappropriate application of a transfer pricing method at the level of the legal entity or at a divisional level can frustrate the clear conveyance of the company's position or create latent error. With confusion comes misplaced factual assumptions that, if left unresolved, can result in a wedge between the company and the I.R.S.' positions.

Transfer pricing documentation serves two purposes – it mitigates penalty risk under Code §6662(d) and it documents the company's reasoning for its selection of a transfer pricing method and demonstrates this method was applied reliably, resulting in the clear reflection of taxable income of the company. For practical reasons, companies often decide to produce documentation to meet only one of the two objectives. Companies often forget to reflect on the purpose of documentation before providing it to the I.R.S. in response to an I.D.R. Taking this step can often help identify future actions required to properly explain the factual or analytical underpinnings of a position and to ensure that these factors are taken into account by the I.R.S. throughout the course of the examination and are identified in the event that the case must be taken to Appeals, Tax Court, or Competent Authority for resolution. This step also helps to uncover certain biases that crept into the documentation and can be exposed under exam with employee interviews, information gathering, and analytical work undertaken for the purpose of verifying documented claims and positions.

IS YOUR METHOD THE BEST METHOD?

The best method rule is written as an explanation of a process of elimination using standard criteria. The documentation requirement concerning method selection is stated in two parts: Companies must describe the method selected and explain why that method was selected, and also describe alternative methods that were considered and explain why these were not selected. While the first requirement is usually handled quite well in the standard accounting-firm style transfer pricing study, the second requirement is usually given only cursory treatment. If C.P.M. is shown to be the best method, it follows that all other methods are not the best method or are only of corroborative value. This approach may be found to beg the question. The company appears to have selected the best method without having carried out the best method analysis as required by the regulations.

Pride of ownership and self-preservation can show through in debates about the best method or the application of the best method with the I.R.S. Though we expect that Insights subscribers are too busy reading to assemble their own modular furniture, some may appreciate the power of the "IKEA effect" as a cognitive bias. Just as people tend to overvalue items of IKEA furniture they have assembled themselves regardless of the quality of the end result, people associated with the selection or application of a transfer pricing method often appear to be proud owners of "dangerously leaning bookshelves." This tendency complicates the introduction of potentially informative corroborative analyses, and reasoned debate leading to an understandable conclusion to a transfer pricing examination, even when not fully agreed.

⁷ Treas. Reg. §§1.6662-6(d)(2)(iii)(B)(4) and (5).

The question of who "owns" or is ultimately responsible for the position often arises. Company executives sign tax returns but may consider the advisor the owner of the position owing to the complexity of the subject matter or the limitations of his or her expertise. Advisors are often of the view that they can do little to maintain the position consistent with their conclusions if the I.R.S. takes an arbitrary or extreme view on a position. The I.R.S. often appears unaccountable for its position or cannot persuade the company or the advisor of the credibility or legality of its position – often "punting" the matter to Competent Authority or Appeals.

Pausing to think objectively about the cognitive biases, strengths, and weaknesses underlying a transfer pricing position is an essential step to take before delving into the technical aspects of the examination itself.

