

# COGNITIVE BIASES, HEURISTICS, BLIND SPOTS, AND PITFALLS IN I.R.S. TRANSFER PRICING EXAMINATIONS

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# Topics

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- Cognitive biases
- Common heuristics
- Use of Code §6662(e) transfer pricing documentation
- Best method dynamics during examinations

# Is This a Transfer Pricing Exam?

<b>TRANSFER PRICING EXAMINATION PROCESS</b>					
<b>PLANNING</b>		<b>EXECUTION</b>			<b>RESOLUTION</b>
Cycle Time in Months					
Prior to Opening Conference	st to 2nd	rd to 4th	th to 30th	th to 31st	nd to 36th
Initial Transfer Pricing Risk Assessment					
Issue IDR for IRC Section 6662(e)					
Internal Planning Meeting(s)					
Exam Plan/Timeline/Key Milestones					
	Opening Conference				
	Risk Assessment				
		Fact Finding and Information Gathering/Issue Development			
		Mid-Cycle Risk Assessment			
				Issue Presentation and Resolution	
				Case Closing/RAR	
				Appeals	
				U.S. CA Request	
<i>THE TIMELINE SHOULD BE USED ONLY AS A GUIDE AND MUST BE ADAPTED TO EACH CASE</i>					

*Transfer Pricing Examination Process, Internal Revenue Service (June 29, 2018)*

# Purpose of a Transfer Pricing Exam

- Tests if an income allocation is necessary to
  - Prevent evasion of taxes
  - Clearly to reflect the income of an organization, trade, or business
  - Ensure in the case of any transfer (or license) of intangible property (within the meaning of Code §936(h)(3)(B)), the income with respect to such transfer or license is commensurate with the income attributable to the intangible.
- Tests the correctness of the application of the Treas. Reg. §1.482-1 best method rule
- Tests the veracity of the facts underlying the method selection and application

# Cognitive Bias

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- A systematic error in thinking, in the sense that a judgment deviates from what would be considered desirable from the perspective of accepted norms or correct in terms of formal logic (Ariely, 2008)
- Presence of strong, unmoderated cognitive bias creates large divergences between taxpayers and tax authorities on how to conduct tests, and what is a reliable test result
- The result is prolonged conflict, misallocation of resources, and double taxation

# Examples of Cognitive Bias

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- Semmelweis Reflex
- Outcome bias
- Law of the instrument bias
- Well-traveled road bias
- Surrogation

# Use of Transfer Pricing Heuristics

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- Heuristics are often the cause of cognitive bias
- An heuristic is a rule of thumb or cognitive shortcut that substitutes a difficult question with an easier one (Kahneman, 2003).
- Examples are: zero price effect, packaging of generic products
- Bob is an opera fan who enjoys touring art museums when on holiday. Growing up, he enjoyed playing chess with family members and friends. Which situation is more likely?
  - A. Bob plays trumpet for a major symphony orchestra
  - B. Bob is a farmer

# Transfer Pricing Heuristics

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- Resale profitability at 2 – 5%
- DEMPE
- Value creation
- Service income is a function of cost
- Hard-to-value suggests use of profit split
- Lots of people means lots of profit
- Implicit support for related parties
- Inexact comparability is non-comparability



# Code §6662(e) Documentation

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- Subject is a transaction
- Narrative description of the transaction and facts, functions and risks of the parties, and assets employed
- Method selection
- Method application, pricing analysis
- Anticipate review or exam requirements
- Adopted O.E.C.D. documentation needs translation to Code §6662(e) standard

# Applying the Best Method Rule

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- The Three Bears temperature gauge, not selection without cause
- The IKEA effect
- Influence of heuristics
- Lack of corroboration or confirmation
- The sources of the best method analysis (people) are often the source of examination conflict

# Important Notice

This presentation is not intended to be legal advice. Reading these materials does not create an attorney-client relationship. The outcome of each case stands on its own merits.