Editorial

On of the most remarkable provisions introduced by the US Tax Reform Act 1986 has been section 1231(e). This so-called 'super-royalty' provision, added to section 482 of the US Tax Code, requires that income derived from the transfer of intangible property (from or to a US corporation), 'shall be commensurate with the income attributable to the intangible'. Under the provision, Congress intends to require corporations to 'look back' and reset royalty rates on the basis of actual profit experience with the transferred intangibles, not just the facts available at the time of the original transfer. This 'second look' approach, which applies even when unrelated party comparables are available, seems not to be consistent with commercial practices between unrelated parties. Earlier attempts by the IRS to apply this approach have been turned down by the courts exactly on the grounds that an unrelated party would not have permitted such later adjustments to the agreement [(*see* R.T. French Co., 60 T.C. 836,854 (1973); *also see* Gulf Oil Corporation, 87 T.C. 30 (1986)].

This, of course, raises the question how the super-royalty provision relates to the arm's length article in treaties concluded by the United States, which follows the traditional arm's length rule of article 9(1) of the OECD Model Treaty.

There are two schools of thinking on the subject. One group of tax authorities take the point of view that article 9(1) is merely 'illustrative' in its scope meaning that while article 9(1) permits the adjustment of profits up to the arm's length amount it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances.

Another group of tax authorities are of the opinion that article 9(1) is 'restrictive' in its scope meaning that the provision prohibits an adjustment of the profits of the resident company, which, while based on national law, would violate the criteria laid down in the article. I do think that – in the absence of any specific reservations in the treaty (as, for instance, may be found in article 9(3) of the US Treasury Model of 1981) – the latter point of view is correct. Simple logical and also historical considerations point clearly into this direction.

Hence, since the Tax Reform Act did not seek clearly to override the treaties in this respect, the traditional arm's length rule in article 9(1) of the treaties should prevent the application of the super-royalty provision.

Unfortunately, the Technical Corrections Act of 1987, which may be enacted during 1988, contains a provision (section 112 (y) (2) (C)) stating that in any case of conflict between the Tax Reform Act's provision and treaties, the Act's provisions are to apply.

I will not dwell on this somewhat light-hearted if not arrogant approach of treaty obligations. It does spell, however, bad news, especially for US based multinationals who can find themselves easily in double taxation positions for which no remedy is available. Article 9(2) of the OECD Model Treaty – the corresponding adjustment provision – would seem not to be applicable if the adjustment of the transfer price is not based on article 9(1).

Taking into account all these uncertainties, there is no doubt that R&D cost-sharing agreements among US and foreign affiliates will become increasingly popular. Congress made clear that it does not intend to preclude the use of bona fide cost-sharing arrangements for R&D and, provided that the income allocated among the related parties reasonably reflects the actual economic activity undertaken by each, no allocation is to be made under the section 482 regulations. The article on 'Cost Contribution Arrangements and Super-royalties' by Messrs. James J. Tobin and Dennis Olmstead in this month's issue is, therefore, of substantial practical value and I recommend it to our readers.

Unfortunately, my personal obsession with the super-royalty issue leaves little room to introduce the other articles of this issue. No doubt, you will find both articles – 'The Taxation of Fringe Benefits' by Mr. J.P. Owens and 'The Canadian Tax Reform' by Messrs. R. Unger and R. Kinoshita – instructive. Finally I am most pleased to have in this issue the first appearance of 'US Tax Scene' by Mr. Eli Fink. Mr. Fink is a well respected international tax practitioner and I am sure we will all benefit from his monthly overview of US tax developments.

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