

Tax and the law in cyberspace

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Given the rapid advancement of e-technology today and the desire to capitalize on it by business, the legal and tax communities have been trying to keep pace with the ever faster moving changes of how business is newly conducted. While there is always a certain lag between the change in technology and its qualification for legal and tax purposes, the international business community needs legal certainty with regard to a wide range of issues, and likewise, the legal and tax authorities have become very aware of the apparent need to protect their respective domains.

This has resulted in the legal and tax communities taking pro-active measures. The first phase was international discussion groups organized by the OECD and the EU as well as many countries' local working groups which have put together papers on their national or even local positions on both legal and tax issues.

While we are arguably still in the pioneer phase of business development on the Internet today, we have moved a clear step forward on the legal and tax front. Many countries now have laws or guidelines which specifically make reference to transactions conducted in cyberspace; others which are not yet so far advanced are moving quickly in this direction.

One common trend can be seen from this pattern both on the legal and tax front line: namely the trend against new regulations to specifically govern the Internet – instead there is a strong international movement to broaden existing definitions to handle the transactions as if they had resulted via more traditional communication media.

This article will treat the current legal and tax developments with regard to doing business over the Internet in Europe today. However, as there are still more trends than definitive answers to how various authorities will proceed, we have decided to take a pragmatic approach in this article towards e-commerce. We have thus set forth various case studies based on examples from the practice where businesses and their advisors need to be careful when doing business over the net. We have then concluded the article with a check list as to what advisors and businesses alike need to consider in the e-commerce age.

Case 1: Swiss software developer

A Swiss software developer creates software modelling tools for the semi-conductor industry. The specific computer-generated programs significantly reduce the development process of new electronic circuits by computer simulation rather than by experimental fabrication of prototypes. All licences of the product are made by the developer directly worldwide and are delivered to customers via the Internet. The customers when possible order the software over the company's homepage (connected to a server located offshore in the Channel Islands).

Legal considerations

As in other continental jurisdictions, the copyright in Switzerland belongs to the originator. The rights of use and exploitation are nevertheless transferable and no legal restrictions apply with regard to the form of such a contract. There

are different possibilities to conclude a contract on the Internet, eg:

- By exchange of e-mail messages.
- By transmitting an e-mail order.
- By accepting a binding offer on a web-site.
- By completing an order form on a web-site.

It is, therefore, possible for the Swiss software developer to conclude the software licence contract via the Internet. The question might occur, however, of whether the online conclusion of a contract is legally binding. The Swiss legislation reflects the general legal principle that for a contract to be concluded the manifestation of the mutual assent of the parties is required (ie both an offer and acceptance have to be clearly communicated between the contractual parties). This manifestation can be either expressed or implied. In particular there may be a problem to prove the receipt of the assent to an agreement concluded over the Internet. For example, if a customer only has to download the software on his PC hard disc by clicking the relevant button on the screen, there is a case of implied acceptance – the supplier nevertheless may have no proof as to exactly who has accepted his offer for the provision of services.

The Internet as a global marketplace enlarges the possibility for contractual relationships between persons with different citizenship. For those cross-border contracts, it is always the question of the applicable jurisdiction. Normally, the contract parties are free to choose any jurisdiction and, in general, no specific legal form is required, although a written form of agreement obviously gives more clarification.

Under the facts above, if no jurisdiction is agreed by the parties, the rules of the Swiss international private law would apply since the contract is governed by the law of the country most closely connected to it. The closest connection is presumed to exist with the country where the party which makes the characteristic performance has its habitual residence or its business establishment (Article 117 of the Swiss International Private Law Act). In particular, contracts on rights in intellectual property are governed by the law of the country where the transferor or licensor has his habitual residence (Article 122 of the Swiss International Private Law Act), which in our case is Switzerland.

Tax considerations

From a tax perspective such a case needs to be approached as follows:

- What type of income does the seller have?
- In what jurisdiction is the income taxable?
- What are the sales or VAT implications?

With reference to the seller's income, Switzerland would

clearly consider the income royalty income from a tax perspective as the company issues licences to a highly specific technical software product to another entity.

In what jurisdiction the income is taxable is another hard question. As a general rule, the income would be taxable in Switzerland unless the licensing takes place through a permanent establishment (PE) abroad – which would accordingly then be entitled to the income. To date a server is not considered a PE for purposes of the OECD Model Tax Convention – thereby in theory eliminating the issue (see however Case 3 below).

What jurisdiction can tax the income also refers to the right of the jurisdiction where the licensee is located to levy withholding tax on outbound royalty payments to the Swiss licensor: this applies even where software is downloaded from the web. Where possible, companies which may be subject to such obligations should be made aware of this point, in particular, at the time of license. While the tax jurisdiction where the licensee is located may – given the status of technology today – never become aware of the software download, many jurisdictions are advocating source-based taxation. Thus at present a general rule has not been decided upon. Nevertheless there is an international debate particularly with general software programs as to whether they constitute sales or licence income and accordingly whether under tax treaties business profits or royalties (ie potentially subject to withholding tax) arise.

From a VAT or sales tax standpoint, the licence of the software may result in the requirement of a self-declaration of the receipt of the import of goods or services, or a requirement to levy VAT or sales tax by the licensor in the country where the recipient is located. Companies licensing products over the net have thus to be sure what the worldwide tax implications of such sales may be.

Case 2: product sharing and manufacturing

Several affiliated companies contribute to the development and design of a technically highly sophisticated product (which could be a train, an aeroplane, or similar). The various group companies are located in different jurisdictions. They provide know-how and technology necessary for the development and manufacture of the product. For this purpose they simultaneously use software applications and interactively develop the product on a central database over the group Intranet. They also use video-conferencing over the net to exchange know-how and experiences.

Furthermore, since putting together such large machines involves so much diverse expertise, they also work with third party engineers specializing in specific cutting-edge fields. This correspondence takes place via transmissions using highly secured encrypted software over the Internet.

Legal aspects

The focus is on the involvement of third party engineers in connection with software encryption on the Internet. There are different procedures for a secure exchange of data, ie encryption or digital signatures. Encryption can prevent an

unauthorized person from viewing the electronic document, and therefore protects the confidentiality of the document. A digital signature proves the authenticity of the sender respectively identifying the origin of a document, and therefore guarantees the integrity of the document. A change of the document during the transmission from the sender to the recipient will be noticed. To create a digital signature, a public key as well as a private key needed. There are organizations acting as certificate authorities or trusted third parties which assign the public key in a legally binding way to an individual or juridical person by issuing a certificate.

Jurisdictions take different approaches in handling the legal aspects of the control and organization of these issues. While the United States stand for a free trade zone in the Internet with no additional legislation, Germany enacted a new Law on Information and Communication Services as well as detailed regulations on the digital signature in 1997. In Switzerland the discussion focuses on giving the digital signature the same recognition as the hand-written signature as well as on the regulation of the public key infrastructure and the certificate authorities.

Tax aspects

From a tax point of view, the intra-group profit allocation is of primary interest. The on-going Intranet in this case makes it very easy to shift profit to a group company located in a low tax jurisdiction. To avoid surprises regarding taxation in the various countries, it is critical to determine the value and ori-

gin of the know-how and technology contributions made by the various group companies and to compensate them accordingly. This is particularly the case since the respective tax authorities will require transfer prices to be at arm's length and will require documentation to verify the pricing allocation.

While finding an appropriate transfer pricing method may be difficult – especially if no comparables are available, a profit split method is one way to compensate the contributions of the various affiliated companies. Furthermore, in so far as a product is being primarily developed over an on-line Intranet connection, on-line time and BIT exchange are also elements a multinational – or the tax authorities – may want to consider in the future when determining the transfer pricing split. Therefore, profit splitting may prove a good approach in most European countries, but nevertheless there are certain countries particularly outside Europe where such methodology is not in favour with the respective authorities.

In our case however, since third parties also contribute to the development of the relevant product, the applied compensation practices to the third parties can and must be taken into account when establishing internal transfer prices.

Case 3: a bookstore

A company sells newspapers, magazines, books and pictures over the Internet. The difference to the traditional way of doing business is that the physical delivery of the goods can be replaced by a digital delivery, ie a download of the respec-

A PRACTICAL CHECK LIST

The following is a list of what your business or clients need to be aware of when doing business over the Internet:

- Always have clear conditions for the conclusion of a contract via the Internet, including: form of acceptance, duration of the offer, expression of acceptance required.
- Have clear conditions with regard to the accepted currency and payment system.
- Include in contracts clear terms as to the applicable law and the place of jurisdiction.
- Review your transfer pricing arrangements with respect to Internet transactions.
- Place your web page on a server in your territory or offshore to avoid any unnecessary PE risks.
- Request purchasers using your web page to provide information as to their address and country of residence regardless of the payment method for the good or service.
- Remind the purchasers of your goods and services that they may have a responsibility to self-declare VAT or sales tax in their local territory.
- Check where business is being done with the EU and the US: if you as a net seller need to be registered for VAT or sales tax in the EU or the US state of the purchaser's residence.
- Keep up to date as to developments regarding VAT and e-commerce.

tive data. Furthermore, one has access to a library of information including normally use of a search engine. One thus does not have to buy the whole book but can often pay per search with credit cards, smart cards or other new forms of cybermoney.

The company has its web page posted on a server in an offshore country. There are several points of presence (POPs) connecting the server to Internet users. The POPs are located in different countries thus guaranteeing that the customer can reach the server on a regular basis. Connections through the various POPs are made randomly, thus no specific connection can be used on a regular basis.

Legal aspects

As mentioned in Case 1, Swiss legislation allows the selling of digitized products such as pictures, books or software where not only the conclusion of the contract, but also the perfor-

mance of the obligation is online. The issue must, however, also be raised whether the contract is considered being concluded among persons present or absent, especially since Swiss law distinguishes the consequences with regard to the time limit of the acceptance and revocation of the acceptance. Although it is clearly stated in the Swiss Code of Obligation that if the contracting parties conclude an agreement via telephone, the contract is deemed to be concluded between persons present, it is not clear which rules will be applicable for a contract concluded via the Internet.

With regard to the applicable law, it also has to be taken into consideration whether the contract to sell movable goods and services is for personal or family use or consumption and is not connected with the professional or business activity of the consumer. In the case that a product is purchased by a consumer, such as the purchase of books, the contract is governed by the law of the country in which the consumer has his habitual residence, provided the marketer received the order in that country and an offer or advertisement in that country preceded the making of the contract and that the consumer performed the legal actions required to make the contract in that country, or provided the marketer prompted the consumer to go abroad and make his order there (Article 120 of the Swiss International Private Law Act).

Based on the above facts, a Swiss consumer who can purchase a book from a web page available via on line access in Switzerland, would render Swiss law applicable. The same applies for the purchase of library services made available over the net or if the bookstore or the library had used e-mail for advertisements or had otherwise placed advertisements in the consumer's country.

Where digital money or cybermoney is used, the main legal concerns are about the security standards of the transmission systems, the confidentiality and the reliability of the orders. As most of the existing payment systems are not compatible, the cybermoney might get lost, be destroyed or get stolen during the transmission between different systems. Another legal issue is the transferability of cybermoney into an officially accepted currency, which is currently not resolved. Furthermore, for feasibility reasons, the user needs to have the right to claim against the editor of the cybermoney. Not only from a legal but also from a commercial viewpoint it is doubtful that many of these systems will survive over the long term.

Tax aspects

The following direct tax and VAT issues need to be considered:

First, the customer will not have to physically buy a book in a European store but can download online the contents of the book or a portion of a library. The jurisdiction which has the right to tax the transaction from a direct tax perspective is dependent on where the seller is deemed to have sold the good or provided the service (home territory or PE abroad).

The primary issue is whether the store is deemed to have a PE in each country in which it is accessible via an online

connection and whether the access connections through various countries are also tantamount to a PE. While it is generally thought that the server or a network itself can not be considered a fixed place of business for the above-mentioned transaction, an Austrian court has deemed a server of a UK service provider to be a fixed place of business for the purpose of declaring a PE.

Furthermore, the German *Pipeline* case lends support for the proposition that the telecommunications infrastructure around an electronic sale may represent a PE at least for foreign telecom providers and possibly traders who have access to the local system. While other jurisdictions take contrary views to the *Pipeline* case, for a practical matter transactions from a server located abroad with different POPs will be difficult to trace.

The PE issue is even more interesting depending on the interactivity of the web page. To the extent that the web page can answer questions and can guide a person through the sale, and perhaps ultimately conclude a sale, it can essentially be considered to replace a person. Thus the issue remains where this computer-employee could eventually constitute a PE.

It thus will be interesting to see whether the upcoming OECD Ministerial Conference entitled 'A Borderless World: Realising the Potential of Electronic Commerce' in Ottawa in October 1998 will bring a new PE solution for e-commerce. Nevertheless for the moment business can most safely avoid PE problems by having their web pages on servers in their country of residence or offshore servers.

On the VAT front the result of the above-mentioned transaction might be a different qualification of the relevant turnover, ie kind of transaction (supply or service) and place of transaction (recipient or provider) compared to the traditional way of doing business. Consequently, a different taxation approach would result for cross-border transactions. Is

the access to a magazine on the net to be considered a delivery/supply of the relevant magazine to the customer and therefore taxable in the jurisdiction where the supplying party (or the server) is located or a service taxable at the recipients location? Different tax rates could potentially apply. Moreover, in some cases a double taxation might occur; in other cases none of the involved jurisdictions might levy any tax.

In view of the latest developments, the EU policy is to consider electronic transmissions of all kinds to be services for VAT purposes. In addition, European countries are trying to find solutions to tax Internet transactions in analogy to traditionally conducted transactions (tax neutrality). Whereas German tax inspectors recently expressed their vision of VAT being collected by companies through which payments for compensations regarding Internet transactions flow (credit card companies, banks or other payment processors). They also indicate their willingness for more numerous and tighter tax audits in cyberspace.

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