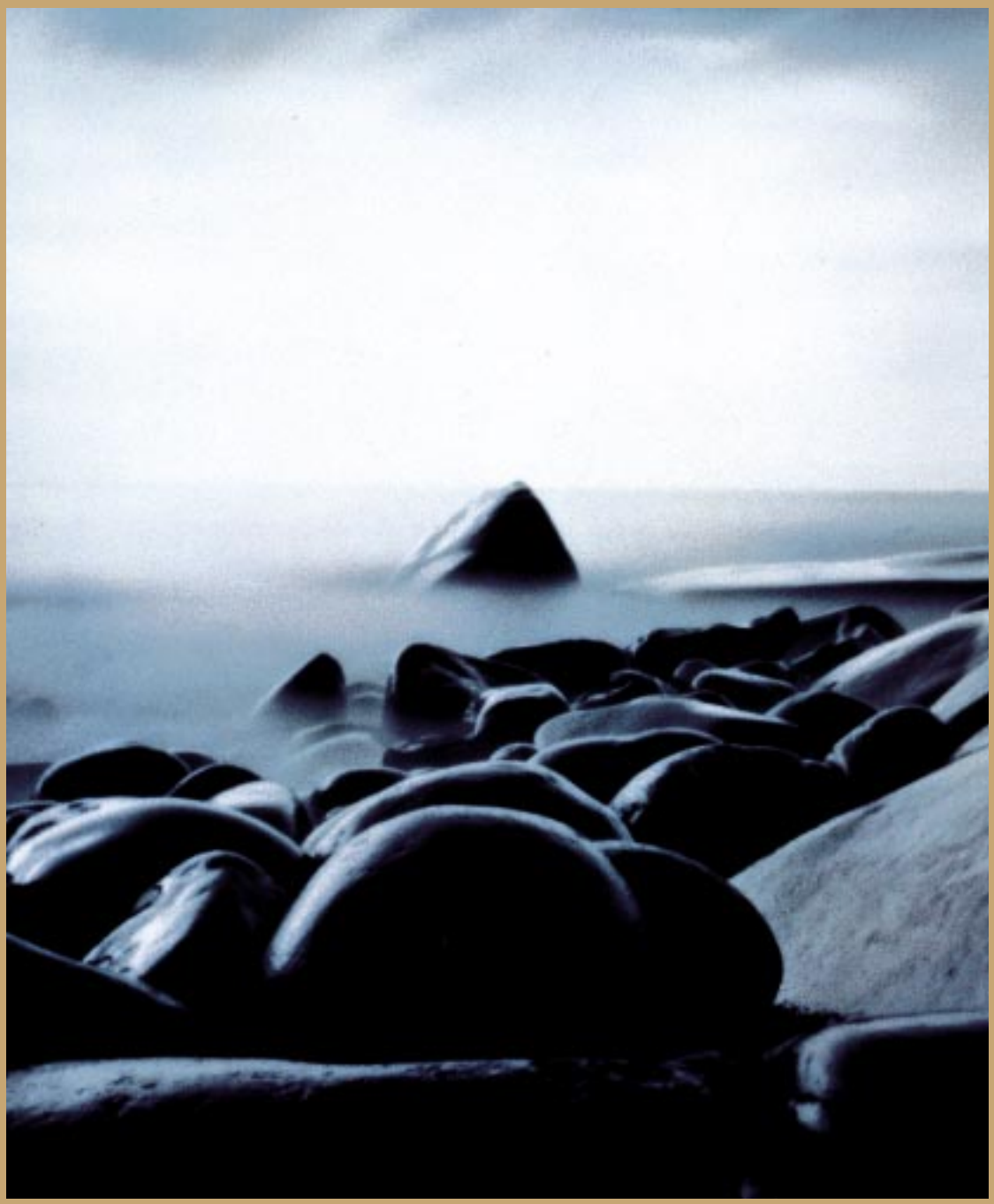
PRICEWATERHOUSECOOPERS

New Territory E-Business:
We can solve your Tax and Legal Problems



With electronic business your sales figures will be a dream – and you'll have a rude awakening when the tax bill comes.

Editorial

There's no business like E-Business. That goes for the tax and legal situation too.

Some impressive predictions are made for business over the Internet - and to date actual results have even eclipsed the forecasts. Companies that integrate E-Business into their structures quickly and efficiently will gain a decisive competitive edge. PricewaterhouseCoopers has made a thorough study of this new type of business and offers an integral, comprehensive service package in the areas of tax and legal consulting services, integrated management consulting, system integration and associated issues.
At present the tax and legal fundamentals in most countries are not adequate for the truly dynamic changes occurring in E-Business. Global solutions must be found, and that will take time. In this booklet we wish to draw your attention first and foremost to the fiscal and legal challenges that can arise from business over the Internet. Naturally it is not possible to deal with the subject areas exhaustively – that would need a whole book – but this booklet can help you to identify problems early on.
In PricewaterhouseCoopers you have a competent partner with in-depth expertise who can find the best possible solutions to problems in this field.

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Contents

The FancyColours Group is headquartered in Zurich. The holding company has branches in ten countries in Europe and Asia. The Bombay branch applied for a leased line to the Zurich

When Walter Weissenberg of FancyColours took a close look at the latest telephone bill he was a little miffed.

head office from a telecom company in India, which in turn ordered the Swiss part of the line on behalf of FancyColours from the Swiss Telecom Company responsible. When Fancy-Colours Finance Director, Walter Weissenberg, noticed that the bill from the Swiss Telecom Company included VAT, he very briefly lost his cool.

Telecommunications and VAT: Pitfalls to watch out for.

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Definition of the telecommunication service

The definition of the telecommunication service and its treatment for VAT purposes can be found by referring to the sector-specific brochure for telecommunications companies issued by the Swiss federal tax administration (ESTV) in June 1998 (610.507-30). Since the brochure is detailed and technical it takes a very good knowledge of telecommunications to be able to apply it in specific circumstances. A telecommunication service is defined as the technical process of transmission, emission or reception of signals, text, images and sound or information of every kind via wire, radio, optical or other electromagnetic media. The following example demonstrates how this definition can apply in practice.

Leased lines

One of the many questions that this issue raises is the distinction between telecommunication services (provision of specific transmission capacities) and leasing of operating equipment (leasing of a specific line). For VAT purposes telecommunication is a service which, to put it simply, is VAT-exempt if it is provided for a foreign customer. Leasing of operating equipment on the other hand counts as the delivery of goods. As far as

VAT is concerned, delivery takes place at the geographical location of the line at the time of transfer. If this is in Switzerland, the customer has to pay Swiss VAT, even if he is a foreigner and never even comes to Switzerland.

take a critical look at the VAT charged in your bill.

Cross-border telecommunications

The real challenges as regards VAT start beyond the Swiss border. It is likely that in future Swiss suppliers has a permanent business establishment in the EU region, it can apply the principle of origin. This means that it can apply the tax rate of the country in which its permanent establishment is located. Since VAT rates in the EU vary between 15%

The incident we related in the introduction to this article actually occurred, although the names and places have been changed. A foreign subsidiary of a Swiss corporation recently asked us for advice. The Asian operation applied to a telecom company in its own country for a leased line to its Swiss headquarters. This telecom company ordered the Swiss section of the line on behalf of the foreign branch from the Swiss Telecom Company responsible. The bills from the Swiss Telecom Company were always issued with Swiss VAT included.

This procedure is not correct because in this case a telecommunication service is provided for a contractual partner domiciled abroad. What were involved here were merely the provision of transmission capacity and not the leasing of operating equiment. The service provided for the foreign company is subject to the domicile principle and is therefore exempt from VAT. To put it simply, it pays to

will serve not only Swiss but also foreign customers, e.g. EU citizens. As soon as the national border is crossed, the regulations start to get extremely complicated.

The existing EU telecommunications regulations will remain in force until 31 December 1999. However, the rules applicable from 1 January 2000 are expected to be very similar to the current ones. Put simply this means that the VAT for telecommunication services is incurred where the recipient uses the service – as is the case with the Swiss system.

Suppliers serving EU customers must therefore ask themselves the following questions:

- In what countries must I register for VAT purposes?
- How must I settle the VAT owed?
- How must bills be made out to the customers?

A Swiss provider serving a customer in an EU country who is not liable for VAT is basically obliged to register in the country concerned. If the provider

and 25% this offers companies opportunities to increase their competitiveness.

There was only a single item on the agenda: «The E-Business strategy of Buser Science

«Ladies and Gentlemen, I'm somewhat taken aback at the scale of ignorance», said Paula Buser of Buser Science Worldwide at the conclusion of the management meeting.

Worldwide». The management of the company that markets books, periodicals and technical publications with great success had prepared for the meeting as best they could - but failed to appreciate the complexity of the subject.

E-Business is the business of the future. But what is E-Business?

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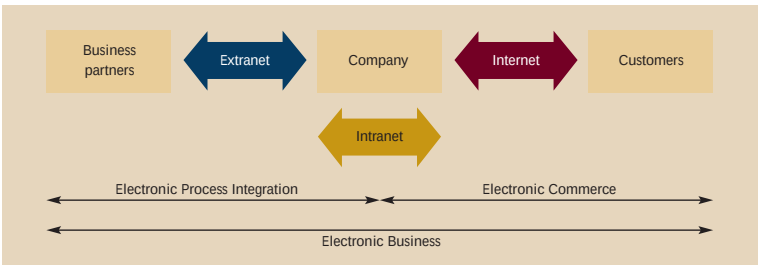
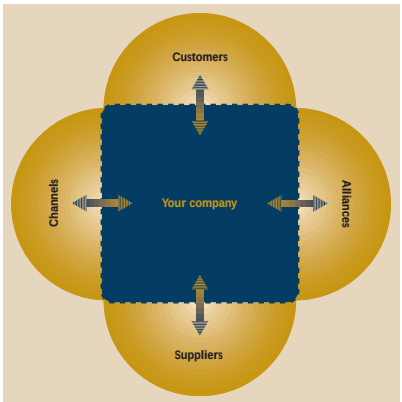
E-Business – a management challenge

The subject of E-Business is right at the top of the strategic agenda of many managers today. And yet, the question remains: what exactly is E-Business? Where does it start and where does it stop? What does E-Business offer? There is still a great deal of confusion over the terms used and many questions remain unanswered. The diagram below shows how we position the terms. This is followed by a few words of explanation and suggestions for proactive measures:



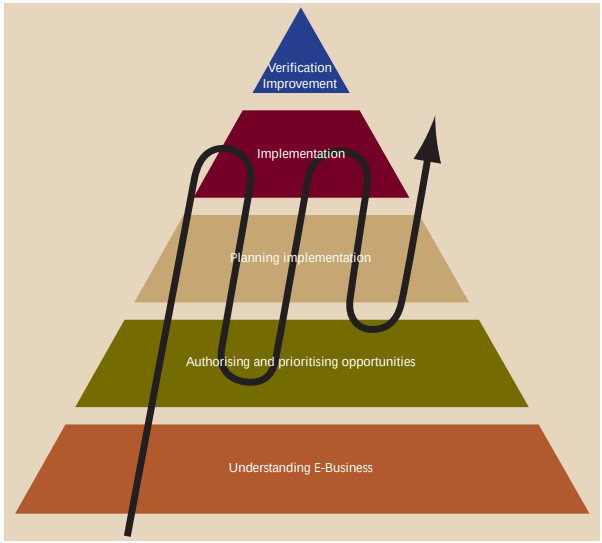
Owing to its potential for radical changes and its significance for all corporate sectors, E-Business really should be on the agenda of top management. Various studies addressing E-Business experience to date draw the conclusion that the prime need is for more awareness in the selection of projects and better integration into existing procedures and systems.



E-Business has evolved from the bilateral, technically motivated transaction of business between predefined business partners into an extensive network of commercial activities. The barriers for entry into E-Business are low and geographical borders no longer have any relevace. This fact, plus other specific features of E-Business, mean that the way in which a market service is provided is to change radically in almost all economic sectors. New roles will arise and value-added chains will be redefined. Almost any attempt to match existing processes 1:1 with E-Business processes is doomed to failure. Defining new business models that make full use of the characteristics and potential of the medium call for an innovative approach. The key to success lies in opening the company to customers and suppliers as well as to new sales channels or alliances.

An Intranet can simplify the exchange of information within a company. It also means work can be carried out on a decentralised basis and decision-making processes can be accelerated. An extranet on the other hand provides a medium for the seamless integration of business partners into internal business processes, offering considerable competitive advantages in terms of pricing and time to market. And finally, thanks to the Internet, businesses can reach a fast-growing pool of potential customers electronically.

This opens up an enormous field of possible E-Business projects, which in most cases can originate from all areas of a company's activities.



However, management faces the fundamental question of which business objectives to aim for and what priority to give them. This calls for the definition of a suitable strategy as well as for methodical selection and careful planning of E-Business opportunities.

Electronic business can be likened to a long journey in several stages. Our experience suggests that there is no direct route. No company can know what the ultimate goal is in advance. Technologies are evolving too rapidly and the actions and reactions of market players are too difficult to predict. Conventional project planning methods frequently miss the target. A more promising approach is the dynamic path that we recommend: it quickly generates usable results and thus directly addresses the ever present uncertainty.

Mrs Kern gave her boss a doubtful look. He'd wanted to make some important changes

«These Internet providers have got a cheek! We'll write them a real stinker of a letter», exclaimed Ralf Guldimann, Executive Director of Swiss-Overseas Travel to his assistant.

to the homepage of this major travel company – but the provider that designed it was absolutely opposed to the idea. «Legally we're on shaky ground, Mr Guldimann,» said Mrs Kern.

Who owns your homepage?

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There's a simple way to get an initial answer quickly: If your Internet service provider also designed the homepage, ask them whether they can give you your homepage data so that you can link this up to another provider. If you had your homepage created by an independent designer, ask whether he can give you the code so that you can make minor changes to the homepage yourself.
If your Internet service provider or homepage designer reacts hesitantly, the reason has to do with copyright law. Unless a computer program – and ultimately that's what a homepage is – has been sold as part of a legally binding transaction, decisions on the scope of application remain the prerogative of the originator or designer. Uncertainty can be avoided only by a clear contractual settlement at the time the order is awarded to the designer or, if the homepage is already programmed, through a codicillary agreement regulating the rights to it. This is certainly a good idea if you want to order an update.
To sum up: If homepage updates were not covered in the design order, you should ask the designer of the homepage before modifying it. It may be advisable to negotiate a supplementary agreement.

The research teams at GlobalGardenGroup (GGG) are delighted: they are now able to exchange research data in real time and can cooperate much more closely than before.

The Internet has the researchers at GlobalGardenGroup (GGG) in raptures.

A first result is already in sight: a new, highly effective, yet environment-friendly fertiliser for balcony plants. Then a small question brings the GGG researchers in Baltimore, Lyon and Uppsala back to earth: Who owns this sensational result? Who is entitled to benefit from which work, and to what extent? And which country can levy taxes on it?

How does transfer pricing work in E-Business?

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What is transfer pricing?

The term «transfer pricing» defines the pricing of transactions between group companies and the way in which the parties concerned are reimbursed for their work. For example, what transfer price must one group company pay another if it accesses the other company's databases directly via the Internet to retrieve specific information? In the case of services between third parties, normal market prices are naturally applied. But within a group it is quite possible that one group company will accept an artificially low price from another company in the group. In almost all countries, therefore, the fiscal authorities have laid down rules stipulating that market prices must be applied between group companies as well. Prices must be «at arm's length». Without such rules, the door would be wide open for corporations to transfer profits to low-tax countries.

Transfer pricing in E-Business

The first step is to ascertain which transactions between associated companies involve E-Business and how these are to be paid for. In a second step, an analysis is made of the opportunities offered by E-Business with respect to transfer pricing – and of the risks entailed.

You therefore have to start by asking what sort of Internet transactions typically take place between group

companies? Take for example data sharing: information held on a database is used by several group companies. The Internet is also used as a marketing tool when one group company refers to other companies in the group on its homepage. Joint research by different companies is not yet very widespread – it is more or less comparable, for example, with global trading by banks. In future, however, the regular exchange of findings between different research companies within a corporate group is set to increase. In the past this type of exchange was physically impossible, since there was no suitable means available to make information accessible selectively to the other-group companies. Nowadays researchers in different countries can communicate online through the Internet. Since many corporations now do research on a global scale, this raises the issue of how to charge for the interchange of work results (i.e. the supply of research findings). All research companies provide a service by feeding research results into the network. Conversely, they also obtain services from the network – and these also include research results. The situation is further complicated by the fact that research frequently takes a long time to produce measurable and marketable results. In fact, research efforts sometimes produce no results at all. Then there is the overriding issue of the ownership of usable research results, plus questions such as who is allowed to initiate R&D expenditure, and who can register as the patent holder in the case of successful development work.

Tax opportunities and risks

It is difficult for the authorities to reach a fiscal solution with the classical transfer pricing methods. On the other hand, politicians and advisers agree that E-Business transactions should be taxed within the framework of the existing regulations. At the present time it is not possible to provide definite information on how taxation would work in the cases described. It will not necessarily be to the disadvantage of taxpayers. With a little planning, it might be possible to find a solution resulting in a lower tax burden. For example, one of the group companies that do research could be tasked with a coordination role in addition to its research activity. It would supervise the other R&D companies and might even commission work from them. It would have control over input into the network and perform all other coordination functions. This company would own the intangibles created and reimburse the other companies for the research work they carry out. It would perform most of the functions and bear the greatest risks, and would therefore receive the lion's share of the profit. It goes without saying that a company such as this should be based in a low-tax country. Nor should it be forgotten that transfer pricing also plays a role for VAT, so the selected strategy must be optimised in this respect too.

The SELECTED SUCCESS mail-order house is an important supplier of luxury products from all over the world. Executive director Max Hochstrasser is

Why principal shareholder Künzli and his Executive Director Hochstrasser recently had a slight difference of opinion about the Internet.

enthusiastic about the new opportunities and potential offered by the Internet. He wants to set up an online database from which large customers can obtain information on the types and quantities of products that are available for immediate delivery and on the delivery dates applicable to specific larger quantities. The principal shareholder, Peter Künzli, turned down the idea. An expert had explained to him that not only customers but also any competitor can call up stocks, delivery times and prices on the web site – and could then bankrupt the company by placing fictitious orders. But Max Hochstrasser was able to reassure him – he'd already discussed the matter with a lawyer.

How can you protect trade secrets in E-Business?

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The transfer of business relations between two or more companies onto an Internet platform creates possibilities well outside our present range of perception – and, unfortunately, opportunities for unscrupulous competitors as well.
Depending on the structure of the just-in-time system, your competitors too can find out at any time whether you can deliver and at what prices. In fact, they can go even further and analyse your cost structure through programmed interrogation of your stocks, delivery times and prices. With automated purchases by dummy companies they could even prevent you from quoting for a particular order at all. Even if you put technical safeguards in place to restrict access to your data to your customers – easily achieved with a modern encryption system – you are still not safe: a malicious competitor could still purchase your confidential data from one of your customers. A customer might do this to recoup the margin you'd refused to grant.

This example demonstrates that the chief risk of data misuse in E-Business is not in the accessibility of your server but rather in the availability of your data to third parties in electronic form. The most efficient way to prevent such practices is through a combination of high-tech safeguards and a contractual regime, which, for example, permits the forwarding of data on a directly commercial basis only. A word of caution though: this contractual network must agree down to the last detail with the prevailing law – otherwise your competitor could bring a competition or cartel action of his own!

Finance Director Koni Lutz was perplexed. Hochstrasser's basic point was right:

«If we use E-Business, why should we waste time writing invoices on paper?» asked Max Hochstrasser, Head of Selected Success

if SELECTED SUCCESS installed an online database for large customers, the logical next step would be a fully electronic invoicing and payment system to replace printed invoices and paying-in slips. But do the tax authorities accept virtual invoices – as proof, for instance, that VAT input tax has been deducted?

«Electronic» invoices and VAT input tax deduction: what is allowed today and what does the future hold?

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The present legal situation

The present legal situation is based on Art. 28, para. 1 and Art. 47, para. 1 of the Swiss VAT Ordinance (MWSTV). The instructions for VAT taxpayer (Z 781) also deal explicitly with EDI (Electronic Data Interchange). The current system can be summarised as follows:

- An invoice within the meaning of the MWSTV is valid only in the form of a document.
- Any paper document is deemed to be a document.
- Electronically transmitted data is not valid for invoice purposes within the meaning of Art. 28, para. 1 MWSTV. Deduction of VAT input tax on the basis of such data is not permitted.
- Electronically transmitted data is acceptable as an invoice if an additional written invoice from the service provider is submitted.

This ruling makes it impossible to operate a fully electronic payment system efficiently because of the necessity of using parallel paper documents. It discourages innovation and, in our opinion, is also untenable in law. In general fiscal law and criminal law

and to a large extent also in contract law, electronic documents and paper documents are treated as equal. However, anyone who disregards the rules today and only sends «electronic invoices» runs the risk that their customers will forgo the right to deduct VAT input tax if they are audited by the federal tax office. Although this can be rectified in many cases by obtaining a subsequent confirmation from the service provider, this is costly in administration terms and the ESVT may possibly charge customers interest on arrears for VAT input tax deductions to which they were not entitled.

The target solution

Rules approving the use of electronic data for the purposes of deducting VAT input tax have been developed in several countries in the European Union. A central problem is the risk of forgery through the use of manipulated electronic data. Suitable safeguards must rule out this risk in the payment system. The following criteria must be fulfilled in order to meet international standards:

1. The origin of the data must be absolutely verifiable at all times.
2. Any change to data must be detectable (integrity). This means among other things that the sender must electronically sign data.
3. Delivery of data must always be verifiable so that the recipient cannot deny receiving it.

Provided these criteria are met, electronic data can rightly be considered at least as forgery-proof as a paper invoice. This is justifiable, especially since a paper invoice that does not even need to be signed cannot be particularly forgery-proof.

The first ray of hope:
A pilot trial in Switzerland

The federal tax office has also recognised how remote from reality the Swiss system is, and favours convergence with the international standards outlined earlier. A fact-finding pilot project has been launched together with three large Swiss corporations in which the all-electronic exchange of data relevant for VAT will be allowed as an exception to the principles explained earlier. Application of this solution is subject, however, to certain conditions:

- There must be a complete audit trail. In other words, it must be possible to follow every business process from beginning to end (VAT declaration) and back again.
- Each participant must keep a chronological transaction logbook in which all EDI messages are recorded in full.
- All records must be presented in such a way that they can be reproduced in an easily comprehensible, complete and unchanged form.

- Verification of origin, integrity and indisputability of dispatch and receipt of the EDI message must be provided by an electronic signatre. A «trusted third party» (certification service provider) must be called in to guarantee the necessary encryption. In this context we refer you to the article on digital signatures.

Another possible solution, though not a very attractive one, would be for both the issuer and recipient of the invoice to write a copy of the invoice onto a CD and to keep this. This would enable the federal tax office to check the authenticity of invoices by cross comparison.

The likely outcome:
Electronic invoices will be allowed.

Almost nobody questions that electronic data should be on a par with paper invoices as regards VAT input tax deduction, a view also upheld by the federal tax office. After completion of the pilot project and analysis of the results, the tax office will be able to draw up workable general regulations. We do not expect a definitive solution in the next few months, as the pilot project appears to have thrown up certain technical problems. We assume, however, that the federal tax office will adopt the solution concept in principle when it is submitted.

If anyone is starting to plan a system with «electronic invoices» today, therefore, they should follow the rules of thumb sketched out above and try to live with the current rules with an easily administered interim solution until electronic invoices are approved by the tax authorities.

Enigmatics' product range includes accessories for the German automotive industry. A few years after production of a particular product cease, the drawings and production plans have no real

Claudia Rieder, Head of Sales at Enigmatics Switzerland AG, is delighted that their server in Berlin is «running hot». Finance Director Fischer reckons it's too early to celebrate.

commercial value any more. But for small garages or private car tuners the instructions could still be quite useful. The relevant plans for German cars have therefore been made available recently to interested parties at a web site in Germany, where they can be downloaded against payment. But this has not escaped the eagle eye of the German taxman. So, must Enigmatics Switzerland AG expect to pay taxes in Germany?

Can a server give rise to foreign tax on earnings?

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The problem

If a Swiss company installs a server in Germany to tap into the German market with its huge purchasing power, or acquires right of disposition by leasing a server, this raises the issue of whether profits earned in this way are liable to German taxation.

To answer this question it is necessary to refer to the German domestic regulations and the provisions of the Swiss-German double taxation agreement (DBA CH-D). It should be borne in mind that the double taxation regulations have no validity for German turnover taxes subject to separate provisions.

What counts as a permanent business establishment in Germany?

According to Art.7, para. 1 DBA CH-D, corporate profits of a Swiss provider in Germany can only be taxed if it carries out its activity through a permanent local establishment. This is defined in Art. 5, para. 1 DBA CH-D as a fixed place of business at which the entire activity of the company or part thereof is performed. The place of business must be within the power of disposition of the company. A permanent establishment does not, however, exist (Art. 5, para. 3 DBA CH-D) if the facility is used by the company solely for specific auxiliary activities or activities of a preparatory nature (e.g. storage, exhibition, dispatch of goods or stock) or for advertising or the transfer of information.

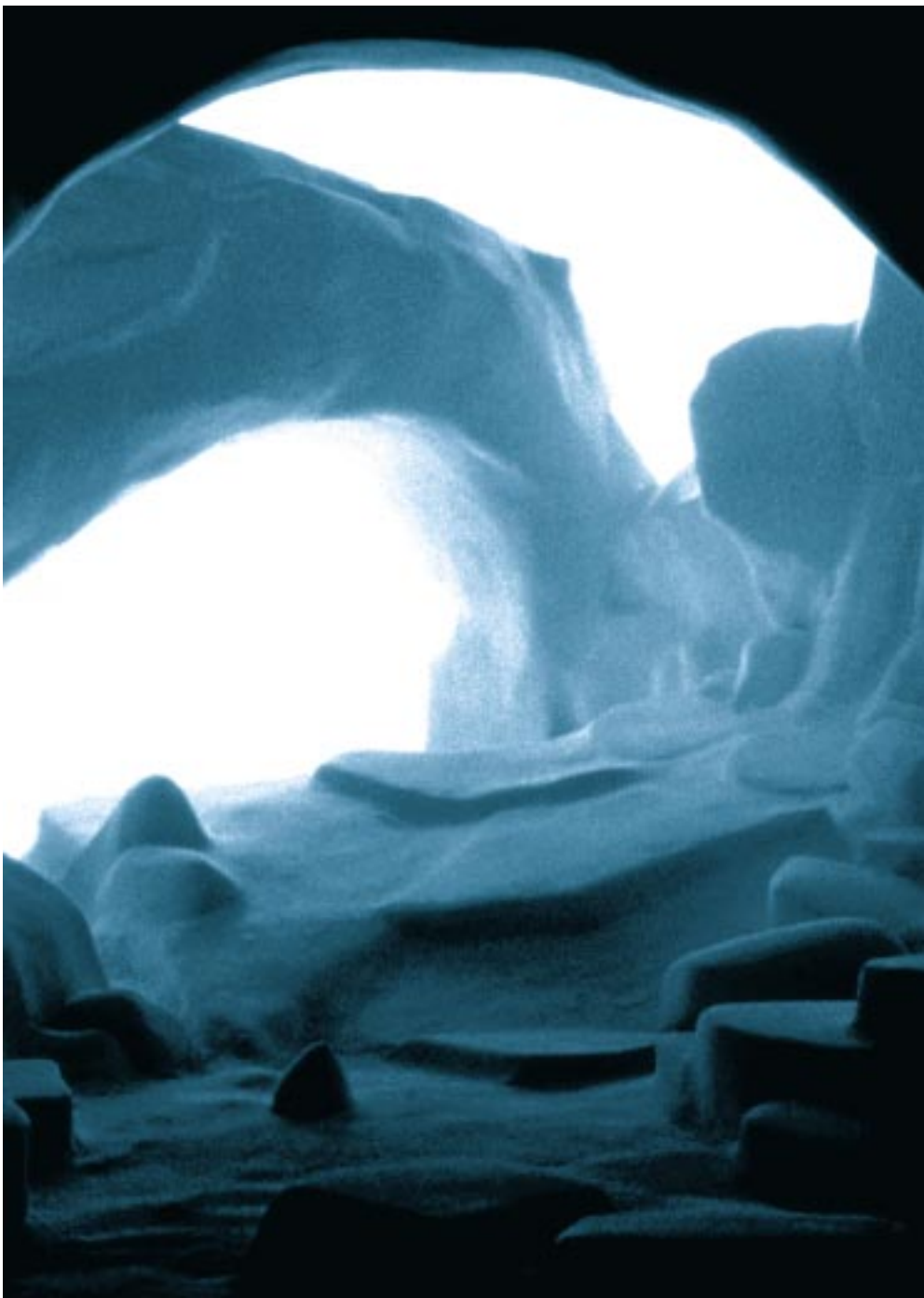
A server owned or leased by the company and permanently connected up at the property is generally deemed to be a fixed place of business within the power of disposition of the company. Whether this could also apply to the leasing of external storage capacities is difficult to assess.

If the device is used only for the storage and delivery of digital goods or for advertising purposes, this would probably only be an auxiliary activity and not apply as a permanent establishment. On the other hand, if the use of the server includes the automatic conclusion of contracts, and if it performs an advisory role, this would go against the assumption of an exclusively auxiliary function.

It is nevertheless doubtful whether a server can exercise the sort of activity necessary for it to be deemed a permanent establishment. The work of automatic machines, e.g. vending machines, would at any rate only count as the exercise of an activity in this sense if the companies' own personnel or independent representatives maintained the machines. In the matter of a pipeline, however, Germany's Federal Fiscal Court ruled that a permanent establishment could also be set up without employing personnel.

The risk of being subject to German taxes

The issue here is whether this ruling is compatible with double taxation law and is applicable to an Internet server. A company always runs the risk that a server maintained in Germany for the German market will be liable to taxation there. To avoid what is known as «limited tax liability» or «trade tax liability» in Germany, companies should therefore refrain from setting up an Internet server in Germany within their power of disposition. A Swiss company will probably not have power of dispo sition – and hence will not be regarded as a permanent establishment – if it leases a server and has no direct access to the web sites placed on the server, i.e. is not able to update and maintain its web site personally. These are just the implications as regards direct taxes. The implications for VAT and possibly also withholding tax are yet to be clarified.



«This will be fantastic for business», she added. Fritz Bürgi, Head of Finance at Transatlantic

«I'm the queen of the world», Donatella Riva of Transatlantic Translations AG called out to her colleagues after finally having installed the long-awaited «Clever Translator» software package from New York.

Translations AG, wasn't quite as happy as Donatella: he'd heard about the risk of double taxation in connection with international software transactions. On top of that, taxes in the contract with the software supplier could be a cost factor. Now Bürgi wanted to know exactly how this business is classified in the USA – and whether it could result in double taxation.

How are software transactions classified for tax purposes?

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1. The problem

Licence payments are subject to withholding tax in many countries (but not in Switzerland). The recipient of licence income is also liable to tax on earnings, resulting in double taxation that can only be reduced or avoided if a double taxation agreement (DBA) exists. However, avoidance of double taxation through a DBA is only possible if the countries concerned agree on what constitutes licence payments. If one country insists that the income is a licence payment while the other country regards it as normal income from a service, double taxation may still apply. Since it is not possible to go into the regulations of individual countries here, we would like to give you a short overview of the rules applicable in the USA (and the rest of the OECD).

2. Software regulations in the OECD and the USA

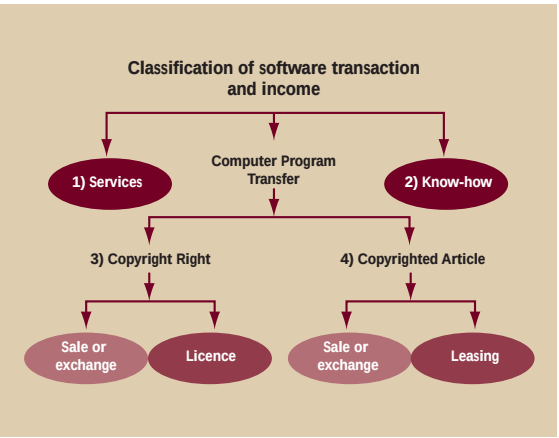
2.1. *OECD*

The OECD has drafted a revised commentary to Article 12 of the standard agreement on the taxation of licences. Since there are far-reaching parallels

with the existing regulations in the USA, we will not go into the OECD interpretations separately.

2.2 *Situation in the USA*
The USA recently adopted final regulations on the classification of cross-border transactions involving computer software. How income from software transactions is classified for tax treatment depends essentially on the nature of the assigned rights:

2.2.1) *Services:* Provision of a service. A software developer who bears no risk for the development of the software provides the purchaser, the bearer of the risk, with a service – namely



the development of software. No licence fee flow.
2.2.2) *Know-how:* Exchange of a company's protected know-how. No licence fee flow.
2.2.3) *Copyright Right:* Transfer of the copyright.
2.2.3.1) *Sale or exchange:* If the copyright in a program code is sold, this is classified as company earnings and taxed as such. No licence fee flow.
2.2.3.2) *Licensing the copyright:* If the copyright is not sold but only a right of use is granted, this usually triggers withholding taxes in the case of cross-border transactions. These can be avoided wholly or in part, depending on whether a double taxation agreement exists. In this case licence fees do flow.
2.2.4) *Copyrighted Article:* Assignment of an article protected by copyright.
2.2.4.1) *Sale or exchange:* The copyright-protected item (e.g. a program) is assigned without restriction. This is classified as earnings from the sale of a copyright-protected article and, as business profit, is subject to statutory tax on earnings for the seller. No licence fee flow.
2.2.4.2) *Leasing:* The copyrighted article (e.g. a program) is assigned subject to restrictions (e.g. only for own use for a specific period). This is classified as leasing income for the supplier and, as business profit, is subject to statutory tax on earnings. No licence fee flow.

3. Case studies
Transatlantic Translations AG has acquired the copyright for the «Clever Translator» program from its developer. Transatlantic Translations AG thus has the right to copy and sell the copyright-protected program. This transaction is classified as the sale of the copyright (see 2.2.3.1).
Transatlantic Translations AG purchases an accounting program from another software vendor for its own requirements and makes regular payments for improved versions (updates) of the program. Whenever Transatlantic Translations AG receives updates it has to send back the previous version. On termination of the contract, the copy in the computer has to be deleted. This transaction is classified as leasing (see 2.2.4.2). If Transatlantic Translations AG were entitled to retain the old versions, the transaction would be classified as the sale of the copyright-protected article (see 2.2.4.1).

Transatlantic Translations AG has problems using the accounting program Y and certain changes are necessary in the program. It is stipulated in the contract with the software vendor that the vendor must adapt this program if necessary to the accounting requirements of Transatlantic Translations AG. These additions to the program are the property of Transatlantic Translations AG, which pays the software company for them. This transaction is classified as the provision of a service (see 2.2.1).

If these program additions involved transferring individual algorithms to Transatlantic Translations AG so that it could make minor adaptations itself at a later date, this would be a transfer of know-how (see 2.2.2).

4. Summary
Detailed analysis and careful planning of transactions involving software and associated rights are indispensable, given the different treatment for tax purposes. Far-sighted planning based on a detailed analysis can be highly effective and help avoid unnecessary tax risks. Since – as mentioned earlier – Switzerland does not levy withholding taxes on licence payments, there is no risk of double taxation for Transatlantic Translations AG in this case. In the opposite case (in which the country where the software recipient is based does charge withholding tax on licence pay ments), the software vendor would need to establish in advance whether there was a risk of dispute over the classification.

E-Business is becoming more and more important for Buser Science Worldwide, a company specialising in books, CD ROMs, periodicals and technical publications.

«How is E-Business taxed in different countries? I can't tell you that off the top of my head,» moaned Gerry Steiner of Buser Science Worldwide in a slightly exasperated tone.

Today 30 percent of publications are already sold all over the world online rather than in paper form. Quite understandably, the principal shareholder and operative manager, Paula Buser, wanted to know how this branch of business is taxed in the individual countries.

«How is E-Business taxed in different countries?»

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Topical questions

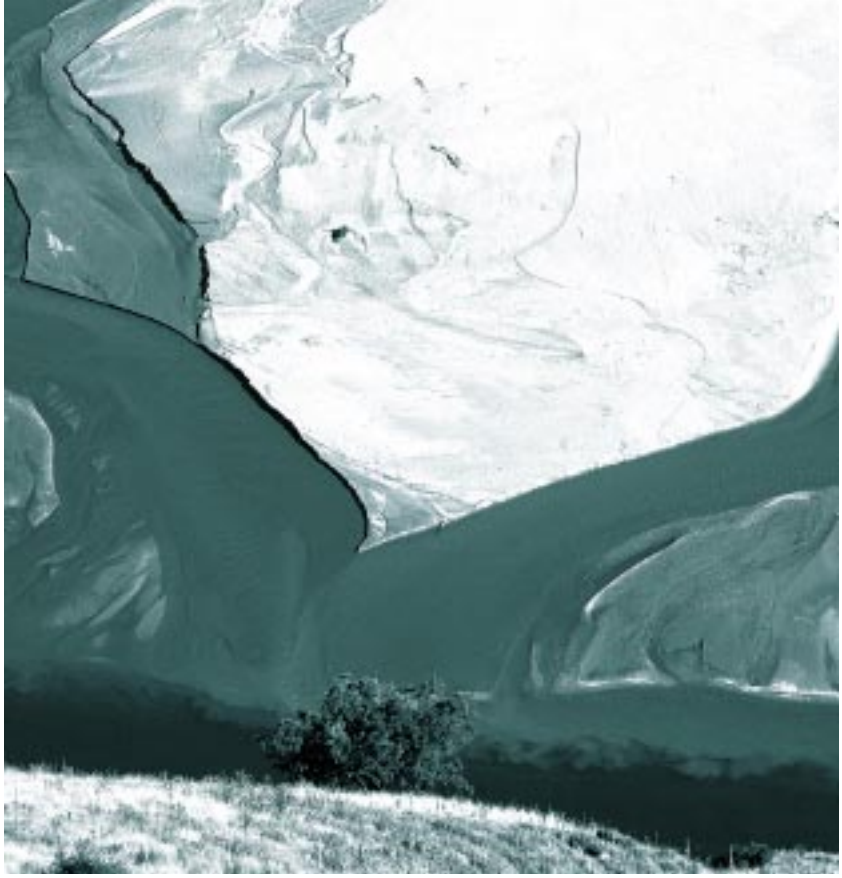
At the centre of the current debate on direct taxes is the question of whether a server can be deemed to be a permanent business establishment – and the criteria by which payments in electronic business are to be labelled as business income, licence fees or payment for services. As far as VAT is concerned, the discussion focuses on the taxation of services and digitised goods imported electronically, the difficulty of tracing the final destination and source of a service and approval of the use of electronic invoices.

International committees are also at work drawing up broadly based guidelines for taxation. Since the taxation of E-Business is clearly a global issue, individual countries should be prevented from going their own ways. This article sums up the debate going on in Switzerland, the EU, the USA and the OECD. The activities of the OECD are of particular importance because this organisation offers the best discussion platform for international coordination of these efforts.

Switzerland

In the current plan of action for promoting electronic business, the federal trade office is also examining the fiscal challenges posed by electronic business. Switzerland's position and objectives can be summed up as follows:

- The aim is to create a tax environment that does not stifle the development of electronic business, while retaining and consolidating the existing tax basis.
- The end-result in terms of the taxation of a business transaction should always be the same, regardless of whether it is transacted in digital form or by conventional methods.
- No new taxes should be created. Instead, the existing taxation principles should be adapted selectively.
- An internationally based framework should be created.



- Information technology should be used to enhance the efficiency of tax assessment and collection. This means a greater flow of data between tax authorities and taxpayers and an efficient exchange of information between tax authorities at the international level.

The plan of action also includes a number of other measures, some of which are described in the other articles in this booklet.

European Union

On 17 June 1998 the European Union adopted a communication to the Council, the European Parliament and the Economic and Social Committee which led to the drafting of guidelines on the taxation of turnover in electronic commerce. According to these guidelines, the 6th EU VAT directive is to be adapted to E-Business. This appears to be a pragmatic solution, in contrast to proposals for taxation based on a bit tax. Powers to introduce new types of tax would thus only be retained as a last resort should it prove impossible to apply existing taxes adequately to the new medium. The guidelines state that a product provided in digital form over the network should be classified as a service for VAT purposes.

Verification of E-Business and fiscal charges is to be simplified, while also making electronic invoicing possible. However, the 6th EU VAT directive has not yet been amended. This requires the assent of all member states and is expected to take some time.

USA

The taxation of E-Business was the subject of a Treasury White Paper as long ago as November 1996. The White House Report «A Framework for Global E-Business» in July 1996 called for equal tax treatment for E-Business. The «Internet Tax Freedom Act» (ITFA) came into force on 21 October 1998. This new law stipulates that access to and use of the Internet may not be taxed in the USA for a period of just over 3 years (from 1 October 1998 to 21 October 2001). Existing taxes are not affected by the ITFA. With this moratorium, the USA has put an end to the hotchpotch of different types of taxation in the federal states and prevented the introduction of new types of tax. In the past a variety of different taxes applied, for example telecommunications tax, Web search tax, taxation as a service or taxation as service packages.

OECD

At the Turku Conference in 1997, the OECD passed a resolution to resolve the issue of taxation of E-Business at global level as a first step. Since the USA is the only industrialised nation not to have VAT and sales tax at national level, this has resulted in divergent types of taxation. By passing the ITFA, the USA has indicated that it wants to adopt a similar procedure but has clearly signalled that it does not intend to introduce any new taxes, for example a bit tax.

The following list of priority work areas for the future taxation of E-Business was drawn up at the Ottawa Conference in 1998:

- Primary application of existing taxation principles;
- Equal treatment of offline and online activities;
- Safeguarding of fiscal sovereignty and fair distribution of the tax burden;
- In-depth treatment of international administrative assistance.

Nevertheless, the OECD is still far away from a global solution for the taxation of E-Business. The international debate on the issue of Internet taxation is still in its early stages.

Breitenmoser's colleague Andrea Schmid was quick to catch on to what he meant: a virtual

«Why don't we go it alone and set up a virtual company? Consulting on the Internet is growing into a megabusiness, and we really could cut down on costly overheads», said Paul Breitenmoser over lunch.

company with no fixed domicile would save not only on administrative costs but on taxes too. The people involved would not even have to commit themselves to each other but simply form ad hoc teams as and when required. The group decided to take a closer look.

How are virtual companies taxed?

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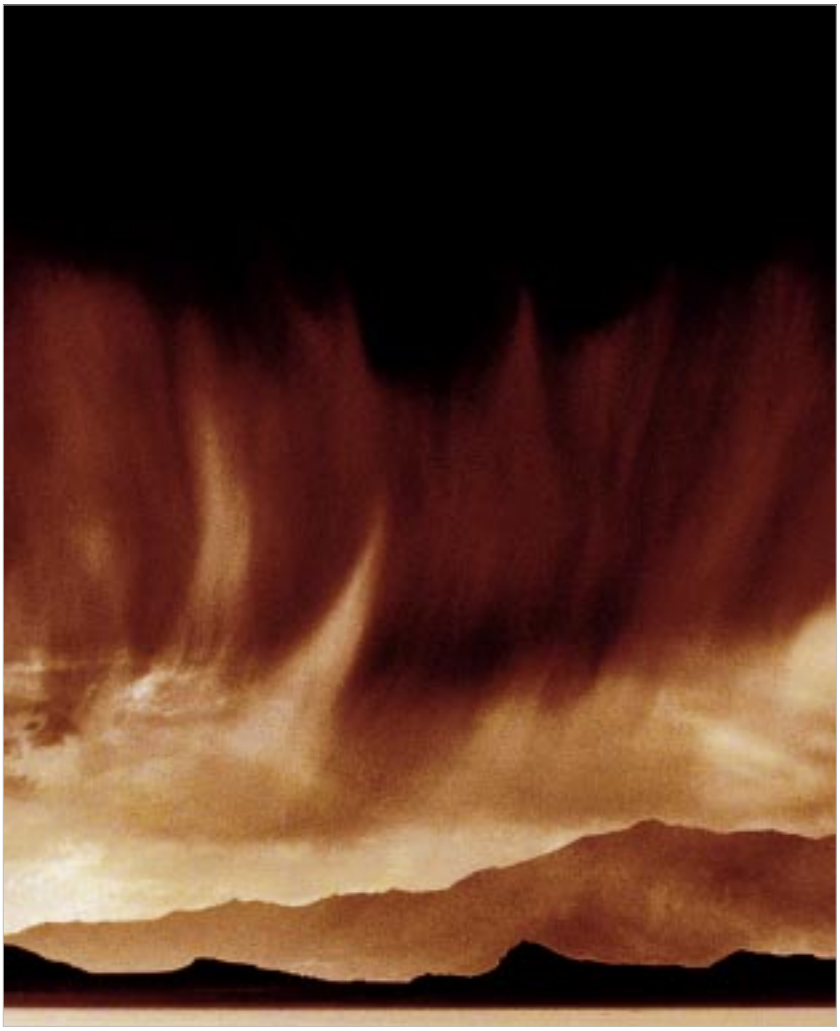
The idea behind a virtual company

Before looking at the tax-related issues of a virtual company, we first have to find out how it operates.

On the homepage www.virtualcompany.ch, the example Virtualcompany.ch shows a loose association of independent consultants working in the IT and telecommunications field. The individual partners bring their own specific know-how, network of contacts and customer portfolio. The result – achieved with minimal overheads – is an artificial or «virtual» organisation capable of rivalling a much larger corporation in terms of the range and extent of services offered. The main advantage of such an arrangement is the networked collaboration between the individual partners. This permits the know-how and time available to be employed in the most profitable manner.

Example: Partner A in a virtual company receives a customer enquiry for the installation of a new network. At the same time, the customer wants to set up an Intranet for the circulation of important internal information and also to implement a mail server with e-mail accounts for all employees. Working alone, Partner A would not be able to accept such an order. Partner B, however, could provide support in

hardware installation, and Partners C and D could be included for the software. With this kind of support, Partner A is now in a position to accept the order. In our example, A approaches the customer as a sole contractor and concludes subcontracts with B, C and D. As in a large corporation, the job is divided among the partners according to the various specialist areas and available resources. Mutual trust plays a key role in such an alliance.



How are virtual companies taxed?
Even a virtual company (unfortunately) has to touch the ground somewhere, at least for tax purposes. In Switzerland, virtual companies are not treated like all other enterprises. For direct (income) tax, only the individual partners – and not the virtual company itself – can be subject to tax. VAT, which we will look at below in more detail, may have to be paid if the virtual company acts as a joint company providing joint services (classification as a civil partnership in accordance with Art. 530 of the Swiss Code of Obligations - CO). In this case, the virtual company would have to register for value-added tax.

Taxation of general contractors
In our example Partner A is acting as a general contractor. By setting the prices accordingly, the 10% fee that is customary in this sector is charged on the orders that are passed on. Two payments are made here: B invoices A for 90 + VAT, for example, while A invoices the customer for 100 + VAT.

Taxation as an agent
If A is not willing or able to perform the incoming order by itself, it is forwarded to B. If the customer is in agreement, B then concludes the contract directly with the customer. For forwarding the order, A receives an agent's commission from B. This commission is classified as a taxable service from A to B and must be invoiced by A to B with the addition of VAT.

Overheads
The (modest) costs incurred in maintaining a homepage and in other administrative tasks of a virtual company can be settled in a number of ways. The simplest solution is for one partner to take on these tasks and then invoice the other partners (with VAT) as if they were customers. Alternatively, the partners could set up a joint «kitty» and use these funds to finance their publicity on the Internet. This structure would have to be viewed as an unlimited partnership which, depending on the sales volume, would itself be liable to VAT. The drawback here is the higher level of administrative costs. Both solutions provide for complete reimbursement of input tax as long as there has been no sales revenue (e.g. training) that is excluded from VAT.
Therefore, it should be clear that virtual relationships might also give rise to some perfectly «normal» tax issues. However, when looking for the simplest solution, it is usually possible to take an existing, conventional approach, as outlined above.

«E-Business is all very well, but contracts for tens or even hundreds of thousands of Swiss francs with no signatures on paper? No way!» Nevertheless, we managed to convince

«Sending purchase contracts for five-digit sums by e-mail? That's got to be a joke – and the competition will certainly think so too!» cried Kurt Bühler.

Kurt Bühler, operations manager at Kunz Tools Unlimited – a heavily export-driven tool manufacturing company – that an unforgeable digital signature already exists for secure and legally binding electronic data transfer.

How secure are digital signatures and what advantages do they offer?

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Validity of Internet contracts

Swiss contract law is based upon the principle of freedom of contract and of form (Art. 11, para. 1 CO). This means that the parties to the contract can themselves decide on the form unless law requires a specific form. Most contracts can thus be drawn up informally, although there are quite a number of exceptions. A contract which simply needs to be drafted in writing in order to be legally binding has to be signed in person by those individuals that are to be bound by it (Art 13, para. 1 and Art. 14, para. 1 CO).

Signatures transmitted by fax do not count as written signatures in accordance with Art. 13, para. 1 CO (ruling of the Swiss Federal Supreme Court 121 II, 252 ff.).

So if, for example, Kunz Tools Unlimited were to purchase components via the Internet, this would pose no problem whatsoever as the contract can be concluded informally and thus also verbally. As far as the law is concerned, the information provided by the component supplier on the Internet represents a non-binding offer, i.e. an invitatio ad offerendum (Art. 7, para. 2 CO). Kunz Tools Unlimited can make an offer to purchase components, which the seller then acknowledges through its acceptance.

Legal security and the advantages of a digital signature

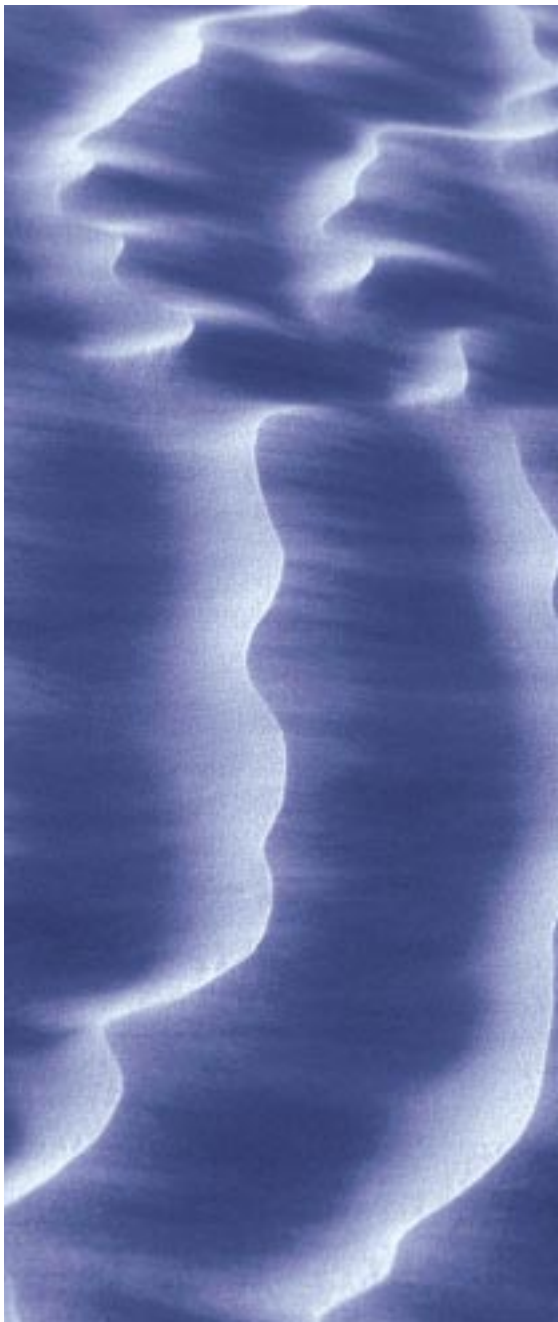
What about legal security? Can Kunz Tools Unlimited be sure that its offer to purchase the components will be received under the conditions agreed upon via the data highway? Can the digital signature play a role here?

In electronic mail, a digital signature having the same legal force (not to be confused with a scanned signature simply inserted into the document) replaces a hand-written signature. Because electronic data can be changed without leaving a trace, an electronic signature procedure has been developed by means of cryptographic methods. This procedure uses encryption and decryption of data to prevent the forging of documents and to identify the originator unambiguously. Trusted third parties known as certification aut-horities (CAs) are assigned the task of authenticating the user. Like a passport office, the CA assigns the network user an electronic identity. From the network user's point of view, the certificate it receives is the electronic equivalent of a passport. The users have two separate codes (asymmetric encryption). The sender first uses a hash function to compress the text to be signed into a hash value (digital fingerprint), encrypts this compressed text with the private key (digital signature), attaches the result as a digital signature to the original text to be sent and then sends it off electronically. The recipient of the message decrypts the signature with the public key, compresses the original text received and then compares this compressed text with the sender's compressed text that has been received and decrypted. If the two compressed texts (summaries of the original text) are the same, this indicates that the original text has been transferred through the data highway without any changes, manipulation or transmission errors.

Legislation on the digital signature

The EU has passed guidelines on the «common framework for electronic signatures». Switzerland does not yet have a legal basis for digital signatures comparable to the legislation passed in Germany in 1997. However, the inter-departmental working group «DigSig» has drawn up two preliminary drafts: a federal law concerning the legal effect of the digital signature (equivalence between hand-written and digital signatures) and an ordinance concerning the public-key infrastructure (governing the technical and administrative requirements to ensure such equivalence).

The ordinance is to come into effect on 1 January 2000. Thus, in order to ensure complete legal security, purchase contracts should be either signed by hand on the old-fashioned paper medium or put off until after 1January 2000 and then signed digitally.



But CFO Jürg Fischer was not going to be drawn onto thin ice so easily. In fact, he had already

«Could you tell us here and now, Mr Fischer, what type of WWW access is taxed and in what way?» asked Claudia Rider, Head of Sales at Enigmatics Schweiz AG a little cunningly.

made a detailed study of the tax-related issues of Internet access, setting up a homepage and buying and selling via the Internet – i.e. conducting e-commerce.

What is there to know with respect to taxation of WWW access?

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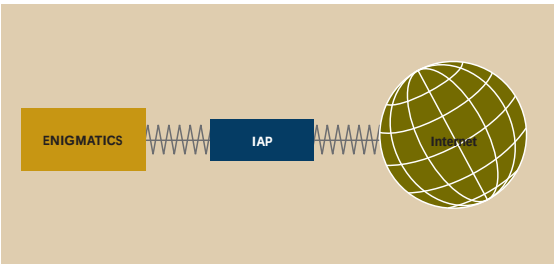
Mr Fischer came straight to the point: in order to access the Internet, Enigmatics has to engage the services of an Internet Access Provider (IAP), which provides access to the Internet by means of a server (see diagram). Enigmatics can choose between what is known as a dial-up connection or a leased line. With a dial-up connection, the Internet must be dialled up each time by means of a telephone line. A leased line, however, provides permanent access to the Internet. The IAP's services (dial-up or leased line) as well as the additional telephone costs incurred during a dial-up connection are subject to VAT at 7.5%.

In certain cases, therefore, a leased line may well be the better choice from a business and a taxation point of view. If the Internet is used frequently and for lengthy periods, the

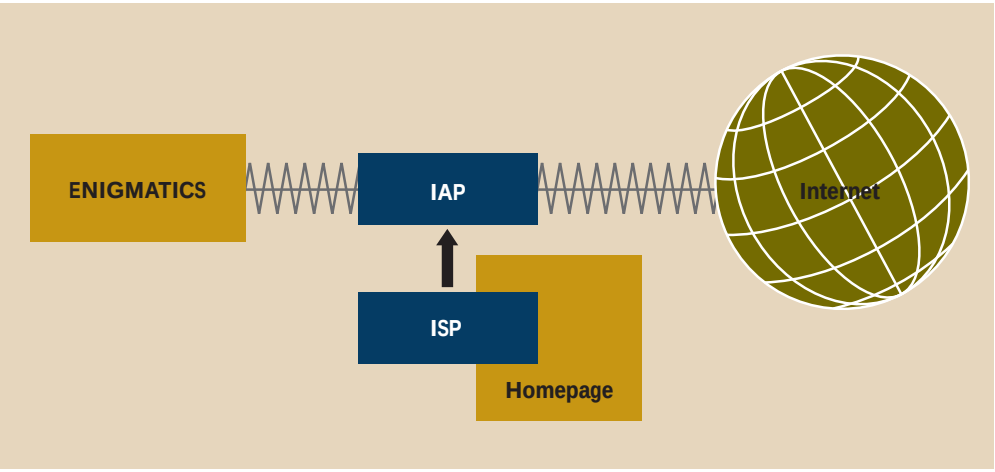


costs incurred in a dial-up connection exceed the price of a leased line and, in addition, more VAT is charged. If the Internet user has no entitlement to deduct input tax (e.g. in case of private individuals) or only a limited entitlement (e.g. banks), the additional VAT incurred represents a genuine cost factor for the parties involved.

Setting up a homepage

Now that Enigmatics has access to the World Wide Web, it wants to set up a homepage to advertise its business activities and attract new customers and personnel.

To design its homepage, Enigmatics commissions an Internet Service Provider (ISP), which may be the same company as the IAP.



The ISP makes Enigmatics an initial proposal, which is a purely informational page to show surfers its address, the history of Enigmatics and the product range.

The design of a homepage by the ISP is a service subject to VAT. If the ISP is located abroad, Enigmatics has to declare and pay tax on a service import. Enigmatics can then reclaim the VAT declared in full as input tax.

In order to place the homepage on the Web, Enigmatics needs to have storage space on an IAP's server. This can be leased on a server within Switzerland or abroad. The issue here is whether the homepage – or, more precisely, the storage space located abroad – constitutes a permanent establishment and thereby a liability to pay direct taxes. If the homepage is merely an informational page, no business activity is actually being performed. Enigmatics can thus work on the basis that it has no permanent establishment abroad. For further information on the subject of permanent establishments, see the article on servers giving rise to foreign tax on earnings.

As the Swiss VAT administration still treats the leasing of movable property (which could possibly include the leasing of a certain storage spaceor of an entire server) as a delivery – a relic from the sales tax which was superseded by VAT – it may well make sense for a Swiss IAP to set up the storage space leased to Swiss residents on a server located outside the coutry. This way the service can be provided to Swiss residents without any VAT.

Selling goods via the Internet

Distance selling / mail order

When the Internet is used merely as a means of ordering, this is called «distance selling» or indirect e-commerce. Instead of shopping in a store, the consumer can send off an order via the Internet, e.g. for a music CD. The CD ordered is then delivered by post (offline delivery). Such services are classified as a delivery with respect to VAT and therefore do not pose any particular problems.

«Delivery» via the Internet

If the product requested via the Internet is delivered in digital form (online delivery), this is a case of direct e-commerce. The customer directly downloads the digitised goods. If the supplier is acting from abroad, the classification of the payment with respect to VAT is of interest. As no goods are physically delivered across the border, only the service can actually be taxed. Consequently, the recipient as a service import should declare the payment. An exemption limit of CHF 10,000 a year exists for recipients not liable to VAT. In reality, however, it is practically impossible for the tax administration to check for compliance with the obligation to notify whenever the exemption limit is exceeded. This is a typical collection problem for the taxation of E-Business, giving rise to tax losses in Switzerland that are very difficult to quantify.

Anyone ordering a music CD via the Internet and downloading it onto a CD-ROM is consuming a service with respect to VAT. In this case, the Internet surfer has a very similar product to the CD bought from a music store. If the CD cover can also be downloaded, the Internet surfer has the exact same product even though this is still classified as a service. The boundary becomes a little fuzzier with software delivered in conjunction with hardware. If, for example, individual software is purchased in connection with a hardware delivery by means of a remote data line, no service has been provided. The software is classified together with the hardware as a delivery and must be taxed at customs.

E-Business: a new territory with boundless opportunities

You have gained an insight into the new and fascinating world of electronic business and become a little more familiar with its numerous different aspects. Although we could not cover all the topics fully, you are now aware of some of the legal and taxation pitfalls that lurk in the many different subsections of E-Business. And you have seen that a wide range of matters have to be taken into consideration to integrate this new business area successfully into your corporate structure.

PricewaterhouseCoopers is the right partner to choose for seizing the market opportunities presented by E-Business. We know the legal and tax-related problems in detail. What is more, we have acquired the entire range of knowledge and competence required providing the right solutions – allowing you to accept this new challenge and operate successfully in the world of E-Business.

PricewaterhouseCoopers – integrated management consulting

PricewaterhouseCoopers, the world's largest provider of consulting services for integrated corporate management, helps its customers to increase their added value, manage entrepreneurial risks and improve their corporate performance.

Drawing on the know-how and experience of over 150,000 employees in 152 countries, PricewaterhouseCoopers offers a comprehensive range of consulting services for market leaders at a global, national and local level and also for public authorities. With a workforce of 2,700 in Switzerland – all people who have specialised in particular sectors and markets – we can tailor our consulting and support to match each customer's individual requirements.

The range of services encompasses auditing and business consulting, management consulting and financial advisory services as well as tax and legal advice.

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