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E-markets ... the next wave?

Christina Rich and Shane Barber provide an overview of the tax and legal implications of the current online phenomenon of vertical and horizontal e-markets.

The first wave of e-business swept consumers into the enticing world of electronic sales via the internet. While ordering online has now become routine for some (purchasing anything from books to travel packages), many dot coms that were established to address this new channel to market have, of late, experienced difficult times in meeting the objectives of their business case. There appears to be any number of reasons for the difficulties faced by the dot coms and their business cases – although those reasons are not the subject of this article.

Whatever the reasons for the difficulties faced by many dot coms, it is the older bricks and mortar companies which appear to be leading the next wave of e-business, producing an explosion in business to business exchanges. These exchanges, or e-markets, bring with them a myriad of tax and legal implications which require particular attention.

WHAT IS AN E-MARKET?

Also known as "B2B exchanges", e-markets involve common groups of entities banding together to undertake B2B transactions.

E-markets can focus on either indirect or specific direct goods and services, and may be built around 'vertical' (industry specific) or 'horizontal' (cross industry) lines. E-markets typically integrate the e-sales and e-procurement systems of all parties in a particular industry, creating a single digital standard for transacting business.

E-markets enable the "many to many" connectivity required to exploit the efficiencies created by early e-sales and e-procurement systems, while allowing companies and their suppliers to begin creating an integrated industry-wide supply chain. For example, assuming 10,000 suppliers deal with 1,000 manufacturers who deal with 10,000 retailers, in an "each to each" system – up to 100 billion electronic data interface connections may be required. Where one hub is used acting as a central conduit, this is reduced to 21,000 electronic data interface connections.

The creation of "B2B exchanges" now allow companies to develop solutions for problems previously accepted as being an integral cost of doing business. For example, by connecting electronically with suppliers, companies can reduce the cost of searching for products and negotiating prices. Likewise, sellers benefit from an expanded global market place and increased volumes.

At the time of writing, approximately 500 such exchanges are in the early stages of development globally, with various estimates pointing to 10,000 exchanges being formed by 2002-2003.

Significantly, consolidation activity is expected to take place at this point, with industry pundits predicting about 500 exchanges to survive beyond 2005.

Consolidation appears to be driven by two main factors:

- the value of an exchange, like a supermarket, grows geometrically as new buyers and sellers are added; and
- companies enjoy greater efficiencies when they can transact business in a single environment.

WHY BECOME INVOLVED IN AN E-MARKET?

The aim of e-markets is essentially to create a major revision of the supply chain. For decades, businesses have endeavoured to drive down the costs involved in buying and delivering products and services. With the advent of the internet, e-markets are enabling businesses to reduce these costs by creating value through their purchase power and price efficiency. Supply chains are integrated, ensuring market efficiency and reducing costs even further.

This trend appears to be continuing. Each company involved in an e-market uses its entry into the exchange (or exchanges in some cases) to facilitate change in their supply chain. Further, it is expected that e-markets will diversify to deliver content, product, consulting, IT and financial services, logistics, risk mitigation and demand planning.

MAJOR TAX AND LEGAL ISSUES

Clearly there are many tax and legal issues associated with the formation of a multi-billion dollar independent enterprise, both for the enterprise itself and the other various participants.

An e-market may have its employees, server, buyers and sellers located in a completely different jurisdiction, identifying difficult questions as to where a transaction occurs. The nature of the income generated and whether withholding or transaction taxes apply are just some of the issues to be dealt with at internet speed.

Some of the major taxation issues facing an e-market are:

- entity structuring and location;
- operational tax and legal issues;
- transaction tax issues;

- human resources tax issues;
- participant tax issues.

Entity Structuring and Location

Companies becoming involved in e-markets appear to be taking advantage of the opportunity to re-examine their tax structure. Weighing up the tax structure of a company whilst investigating e-business opportunities makes sense from both a cost recovery and timeliness perspective. E-markets create value in different ways. Given the "blue skies" nature of an e-market, it can often make its "tax footprint" (where the entity's taxable presence resides) be decided by a reference to where it has people, activities or web-sites (where the value is added).

Identifying where value is added and addressing where it should be placed has a potential to add millions to the company's after tax profit. For example, an e-market residing in the United States will pay 40 cents or more in Federal and State taxes, however, with careful planning, the entity can be established outside the US and overall tax reduced to 15%.

An issue particular to e-markets is the commercial arrangements whereby founding shareholders commit to put a certain volume of business through the e-market. Failure by the shareholders to meet their commitments in this regard may result in changes to the level of shareholding interests. Usually, such proposals take place with no consideration, but if they involve disposal and acquisitions, they have tax implications.

Another issue to be dealt with is withholding tax. Withholding taxes on the fees or income generated by an e-market can quite easily destroy marginal profit.

Operational Tax and Legal Issues

E-markets face the same tax and legal issues as any other business, but without the luxury of being able to build an internal tax capability over time. E-markets must be diligent when it comes to dealing with taxation issues. Tax authorities will not want to see their tax-take eroded with the crumbling of boundaries and will seek to use techniques to protect their revenue base. For example, the Australian Tax Office ("ATO") has already had preliminary discussions with at least one proposed Australian exchange and has made initial inquiries of some of its participants. The ATO will be seeking to understand the issues and ramifications on its revenue base arising from e-markets as quickly as possible.

It is doubtful that tax authorities will be sympathetic to e-markets that ignore tax issues arising from their activities as a large amount of revenue is at stake. It is also not enough to say that the e-market is based in one jurisdiction and therefore has no offshore tax issues. If the e-market facilitates buying and selling with any offshore parties, then taxable presence and indirect tax issues will still arise.

Businesses looking to enter an e-market could also easily under-estimate the range of legal issues involved. Particularly during the start-up phase, competition and other regulatory issues for each jurisdiction will be involved. To be involved needs careful consideration. Signing parties should sign appropriate agreements establishing the basis of their involvement – including the settlement of any ongoing costs, subsequent profits or losses and the basis of the entry for additional participants or entity partners.

All of the usual corporate governance issues associated with setting up a legal entity apply to e-markets and therefore need to be addressed and documented. In addition, far more complex market governance rules need to be drafted and observed from day one of operation of an e-market.

Legal issues impact almost every area of infrastructure – including human resources and recruitment, risk management and insurance, registration and protection of intellectual property, marketing and advertising. Acquiring the software and hardware needed, developing and hosting the online marketplace and outsourcing non-core services all present legal challenges which need to be addressed.

The complex web of relationships created by e-markets means that a strategic view of allocation of liability amongst all participants must be considered at the time the e-market model is designed and not left to negotiation of each individual arrangement.

Once the foundations are in place, legal issues remain critical during the start up of the e-market itself. Arrangements must be established:

- between the e-market owner and its buyers and suppliers;
- to establish terms for the use of the e-market;
- for auctions to be held via the e-market;
- for access to and disclosure of information.

This latter issue should not be overlooked, particularly in the Australian market, in light of the extensive federal debate on privacy issues. Impending implementation of legislation will codify the already widely adopted *National Principles for the Fair Handling of Information*.

Other relevant legal issues include matters such as the website content and authentication, and enforcement of contracts made over the internet.

Transaction tax Issues

E-markets pose a host of indirect tax problems and opportunities. The sheer volume of throughput and associated transaction fees and service fees cause an indirect tax compliance dilemma for the e-market itself. Add to this the indirect tax position of the participants in the exchange, the shareholders, suppliers and buyers, and the potential burden collectively arising from the exchange can become onerous. Conversely, many opportunities are brought by technology to systemise global indirect tax compliance, not only for the e-market itself but for its participants.

Meeting the various indirect tax requirements – including multiple registration and tracking resale certificates and origin data – will either be conducted at company level or through information hosted by the exchange.

Human Resources Tax Issues

E-markets are competing with new dot com ventures for the right people for their business. As such, they need to carefully plan their HR strategy. E-markets need to identify the people in the already highly competitive employment market who can work in the very high growth internet environment, understand what is going on and identify the drivers behind the business. Competing with dot coms means that e-markets need to have innovative remuneration structures involving new style share options, retention strategies and the like. The tax issues behind such structures must be addressed to ensure that employee benefits are not eroded.

Participant Tax Issues

With proper planning; a company's e-business development efforts can be enhanced by designing structures to minimise the taxes resulting from its e-business initiatives. The net value created by e-business transformations can be increased through tax planning by 20% or more if the right business facts and tax planning are present.

SINK OR SWIM

In the same way that companies at the beginning of the industrial revolution knew business was changing but did not know how it was going to turn out, no one can predict the next wave of the technological revolution. However, it is clear that the bottom line is e-business and that e-markets appear to be the next wave in this phenomenon.

Not only does business need to ensure that it takes advantage of the e-markets and the benefits they have to offer, it is vital that proper consideration is given to tax and legal issues arising for both the e-markets and its participants.

E-markets present companies with an opportunity to revolutionise the supply chain and save money, but e-business is just business evolving and therefore must be approached with the same degree of caution as any other business venture.

The views expressed in this article are those of the authors and not necessarily those of their firm or their clients.

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The New Digital Copyright Law

Raani Costelloe examines the Copyright Amendment (Digital Agenda) Act 2000 providing both an insightful analysis and in depth discussion of this long awaited revision to the Copyright Act.

The *Copyright Act 1968* (**"Copyright Act"**) has finally been overhauled to address the digital revolution and the internet by introducing a new right of communication for copyright material and numerous other amendments which reflect the outcome of intense lobbying by owners and users of copyright works and other subject-matter. This follows more than six years of deliberation, it being that long since the Copyright Convergence Group (**"CCG"**) was appointed in 1994 by the then Federal Labor Government to consider the need for changes to the way in which the Copyright Act protected broadcast and other electronic transmissions with regards to changes in technology and communication.

In that time there has been a shift in focus from traditional media such as satellite and cable broadcasting towards interactive media and the issues raised by the ubiquitous digitisation and reproduction of copyright material on the Internet.

The *Copyright Amendment (Digital Agenda) Act 2000 (6th)* (**"Digital Copyright Act"**), which substantially amends the *Copyright Act 1968* (6th), was enacted in early September 2000 and will come into effect in early March 2001. The rationale behind the amendments commencing six months after enactment is to allow affected parties to consider and/or re-negotiate present practices, contracts and arrangements in light of the major changes which have been made to the Copyright Act.

This article focuses on the evolution of the copyright reform process, the effect the changes will have on the media and communications industry and the outcomes of tensions between rights holders and copyright users, in particular:

- the new right of communication to the public;
- the scope of licensing regimes and online use of music;
- the status of temporary reproduction in the course of internet browsing;
- liability issues relating to telecommunications carriers and Internet Service Providers;
- the re-transmission of free-to-air broadcasts by pay television operators; and
- technological protection measures and protection of rights management information.

The Digital Copyright Act also deals with a range of other issues which will not be discussed in this article, such as fair dealing in the digital environment, use of copyright by educational institutions and the protection of computer software.

THE RIGHT OF COMMUNICATION TO THE PUBLIC

The period since 1994 has seen fundamental changes in the focus of the copyright lobby and the communications industry generally. Initially, the main concerns related to new forms of broadcast technology and business models which were being introduced in Australia in the early 1990s, namely satellite and cable pay television and the re-transmission of free-to-air broadcasts by pay television operators.

Since then, the focus and language of rights has significantly changed to reflect the transformation in the way copyright material may be reproduced, transmitted or communicated over the internet and other cable and wireless networks, such as broadbanded cable and mobile wireless application protocol ("WAP").

The gaps in the existing broadcast and diffusion rights

In 1994, the CCG recommended that the existing broadcast and diffusion rights be replaced by a broad technology-neutral transmission right. The current broadcast right is limited to wireless transmission. The diffusion right, while related to transmission over a material path, is restricted to subscriber services.[1] In addition, sound recordings do not have a diffusion right. The effect of this is that owners of copyright in sound recordings do not have a right against any person transmitting sound recordings over cable or wire networks.

The other effect of the definition of broadcast being restricted to wireless transmission relates to a broadcast being a copyright subject-matter in itself. That is, the Copyright Act recognises that a separate copyright exists in the actual broadcast transmission by a television or