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WebMindLicenses case: Abusive practice?

Background of the case

WebMindLicenses (WML) is a Hungarian software company, WML licensed website and knowhow rights to a Portuguese company (Lalib) which exploited the software to run an adult website. (erotic interactive audiovisual services) The software enabled Lalib to offer interactive audiovisual content via a website to individuals throughout the world. Under the terms of the license agreement, WML remained responsible for ongoing maintenance and development of the software.

Output VAT on payments received for these services was accounted for in Madeira where Lalib was established. At that time, the place of supply of electronically supplied services was the country in which the supplier was established (this changed from 1 January 2015). Consequently, when offering the services from Madeira, the Portuguese 13 percent VAT was due. Hungary has the highest standard rate in the EU of 27 percent.

Following a tax inspection, the Hungarian authorities considered that the transfer to Lalib was not a genuine economic transaction and the relevant supplies were actually made by WML in Hungary, rather than Lalib in Portugal. so the Hungarian VAT was due on the payments. The taxpayer was assessed for over €33 million, rising to around €68 million, including penalties and interest.

The authorities considered WML had committed an abuse of rights by giving the impression of being based in Portugal, in order to circumvent Hungarian tax law and qualify for lower relief in Portugal. The decision was based, in part, on the fact that Lalib had no capacity to operate the website concerned itself and therefore subcontracted its operation to contractors with whom the sole shareholder and director of Lalib had close personal ties.

They based their decision on evidence which had been obtained covertly by other state authorities. Parallel to the tax proceedings, a criminal investigation had commenced and the investigating authority had recorded telephone conversations of senior personnel at WML and Lalib.

WML appealed against the decision and challenged both the allegation of abuse and the use of the covertly obtained evidence.

The Hungarian court referred 17 questions to the CJEU, which related to (1) whether or not the transaction at hand was fictitious and had no real financial or commercial content and (2) whether in the case at hand there was an abusive practice.

The reference also contained questions around the Regulation No 904/2010 on administrative cooperation and on the use of evidence obtained without the taxable person's knowledge as part of a criminal investigation.

Advocate General Wathelet's Opinion

The Advocate General (AG) considered that under the Halifax abuse test, choosing a foreign place

of business could constitute an abuse of rights where the essential aim was to obtain a tax advantage contrary to the purpose of the VAT Directive, and where there was no other justification for having an establishment abroad.

AG's view was that in order to satisfy the Halifax principle, the national court would have to find that the licensing agreement was fictitious and created for the sole purpose of giving the impression that the benefits in question were provided by Lalib in Portugal, when they were in fact provided by WML, or that the establishment in Portugal had no substance.

In the view of the AG, the license agreement was not fictitious, or for the sole purpose of obtaining a tax advantage. There were commercial reasons for appointing Lalib. Hungarian banks would not offer payment systems to providers of adult websites. No one in the WML group had a sufficient network of relationships or appropriate expertise to enable the website to be operated internationally. Lalib had a permanent structure, was autonomous, and met its tax obligations in Portugal.

The AG noted that at the time the first licensing agreement was signed with Lalib, the VAT rate difference between Hungary and Portugal was only 4%. He considered such a margin was unlikely to be the sole reason for the arrangements.

In reaching his conclusion, the AG re-iterated a point which has been made at various levels by both the UK and European courts. It is perfectly acceptable for taxpayers to structure their affairs so as to limit their tax liability. However, in order to avoid the Halifax principle, there must be commercial reasons for the arrangements and transactions carried out. In this case, the AG considered there were commercial reasons for appointing Lalib and the transactions were not therefore abusive.

The AG also said that the seizure of emails without judicial authorization and the lack of opportunity for WML to verify the existence of any such authorization for intercepting telephone calls, did not respect the principle of proportionality, referred to in the Charter of Fundamental Rights of the European Union 2000 (the "Charter").

If the national court finds a violation of WML's fundamental rights as contained in the European Convention on Human Rights and the Charter, any evidence obtained illegally or improperly used should be excluded. It will then be up to the national court to decide whether the admissible evidence is sufficient to support the tax adjustment decision of the Hungarian tax authorities.

The AG's opinion confirms that carrying on a business from a member state with a lower VAT rate is not abusive, provided there are genuine commercial reasons for doing so.

The judgment

The key points from the Judgment are:

On 17 December 2015, the Court of Justice of the European Union (CJEU) ruled in the WebMindLicenses case (C-419/14). This case relates to the question whether or not a licensing structure can be seen as an artificial structure or as abusive. In my view, an interesting case, as this was the second CJEU VAT case in which the CJEU adopted a "substance over form" approach (also see CJEU Paul Newey (C-653/11))

Following established case law, the CJEU ruled that taxable persons are allowed to structure their businesses so as to limit their tax liability. Enjoyment of a difference in (VAT) rates between EU Member States is not a tax advantage which is contrary to the objectives of the VAT Directive, as this difference is a consequence of incomplete harmonization, and so did not lead to a finding of abuse.

The CJEU ruled that the arrangements in question would be abusive only if they were "wholly artificial" and concealed the fact that the services concerned (i.e. the operation of the website) were not actually supplied in Portugal but in Hungary. The sorts of factors which would be relevant to establishing this included where Lalib was physically based in terms of premises, staff and equipment. The CJEU also considered whether Lalib carried out the relevant economic activities in its own name, on its own behalf and at its own risk and whether it had the appropriate structure, in terms of premises, human and technical resources to carry out those activities.

That the know-how was created by the sole shareholder and director of WML and that he had control over its exploitation; that the website was operated by subcontractors and the reasons that WML had not exploited the know-how itself were not found to be decisive. In addition, the CJEU commented that the fact that a transaction was subject to a lower VAT rate than it would have been had it been carried out in another jurisdiction did not, in itself, make it abusive.

Furthermore, according to the CJ, the fact that VAT had been paid in another Member State does not preclude an adjustment in the Member State in which those services have actually been supplied, in the case of abusive practice. In that case, the tax authorities of the latter Member State are required to send an information request to the tax authorities of those other Member States if that is useful, or even essential.

In order to establish that the transaction (i.e. the license agreement) arose from an abusive practice, it would be necessary to show that the agreement constituted a wholly artificial arrangement. Consequently, the referring court would need to determine whether Lalib's place of business or fixed establishment in Madeira was genuine, whether it had an appropriate structure in terms of premises and human and technical resources to make supplies and whether it engaged in that economic activity in its own name, on its own behalf, under its own responsibility and at its own risk.

The ECJ noted that the place of creation of the know-how is not decisive – even in a case such as this, where the creator had significant control and influence over the business. Similarly, the location of back office functions and the location of subcontractors was not a decisive factor.

Comment

The ECJ has confirmed that carrying on a business from a member state with a lower VAT rate is not abusive, provided there are genuine commercial reasons for doing so. It has also provided some helpful guidance on the relevant factors which national courts should take into account when determining whether a licensing arrangement is genuine or not.

Evidence obtained in criminal investigation

The reference also contained questions around the Regulation No 904/2010 on administrative cooperation and on the use of evidence obtained without the taxable person's knowledge as part of a criminal investigation.

Intercepted telephone conversations and seized emails from an ongoing case were used as evidence in the tax case without WML's knowledge.

WML argued that this was in conflict with its fundamental rights under the European Treaty, including its right to a fair trial; its right to a defense and its right to access data collected about it.

The question has been raised whether this information was obtained illegally? If the evidence was obtained illegally in the criminal proceedings and this had not yet been established, can that evidence be used in tax proceeding?

The CJEU agreed with WML that actions such as interception of telecommunications and seizure of emails interfered with a taxpayer's rights under the Treaty and noted that any such interference had to be justified on the principle of proportionality.

It therefore provided guidance on when a tax authority could use evidence obtained in a criminal investigation in civil proceedings against a taxpayer without breaching that taxpayer's rights under the Treaty. The CJEU held that before admitting such evidence, the national court must verify that the way the evidence was obtained was compatible with national law and necessary in the context of both the criminal procedure and the civil procedure. The national court also needed to establish that the taxpayer had access to the evidence obtained about it and an opportunity to be heard. If these requirements were not met, the evidence obtained in the criminal procedure should be disregarded in the civil one.

The European Court of Human Rights has adopted the position that the use of illegally obtained evidence, particularly evidence obtained in violation of Article 8 ECHR which guarantees the right to respect for private life, does not necessarily lead to unfair proceedings. The position of the Court is that it should normally be left to national courts to decide on the admissibility of evidence, which is a matter essentially left to the regulation of national law .

Whether or not Article 6(1) ECHR is violated will depend on whether the evidence could be contradicted in trial, whether it was the only evidence on which a conviction was based, or whether, because of the way the evidence was collected – for instance by inducing a person to make certain statements or to commit certain offences which would not have been committed but for the active role played by the public authorities – it should be considered to violate the right not to contribute to one's own incrimination (the right to remain silent) or to be akin to provocation to commit an offence.

Hungarian court decision:

Following the judgment of the Court of Justice of the European Union in the preliminary ruling case the court of first instance quashed the tax authorities' first and second instance decisions and ordered the first instance tax authority to reopen its administrative proceedings. In its judgment, the

court reached the conclusion that the tax authority did not examine Lalib's place of business, its structure, whether it had human and technical resources to make supplies and whether it engaged in that economic activity in its own name, on its own behalf, under its own responsibility and at its own risk. The tax authority didn't make any enquires to the Portuguese tax authorities to find out the real facts, its decision based solely on the contested evidence obtained in criminal proceedings, and handed over without legal authorization.

Due to the law Hungarian rules:

„The data related to law enforcement activities, as well as other data obtain under Section 78, shall be processed separately, and - unless otherwise provided for by law - may be used only for the purpose for which they were originally obtained.”