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Ending regulatory avoidance through the use of letterbox companies

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Policy recommendations

Labour rights and public finances in the EU are under threat by the increasing use of letterbox companies by corporations to evade tax payments, collective labour agreements, labour laws and social security contributions. Letterbox companies are enabled by policies at national and EU level that facilitate corporate 'regime shopping'. Any instrument facilitating company mobility in the EU or Member States should introduce effective safeguards against regime shopping. These safeguards include: making corporate groups (i.e. legal entities under one ultimate beneficial owner) liable as single legal entities under EU and national laws, to end wide-spread abuse through separate legal entities and limited liability at subsidiary level; full transparency regarding beneficial ownership and directors of companies (including European lists of disqualified directors and fraudulent companies); and the introduction of a common European definition of genuine economic activity.

Introduction

Letterbox companies are legal entities set up by businesses to benefit from a regulatory framework in a jurisdiction in which they have little or no material operations. They enable 'regime shopping' for lower taxes, wages, labour standards and social contributions, as well as for different legal rights under bilateral treaties. Letterbox companies have been used for many decades in the tax and financial sectors to avoid domestic taxes through treaty shopping and to gain international investment protection through Bilateral Investment Treaties. They are used generally to structure international holding and finance activities (Knottnerus *et al.* 2018). According to research commissioned by the European Parliament, a conservative estimate of the costs to the EU of corporate tax avoidance alone is €50-70 billion annually (cited in Ryding 2018).

Trade unions first identified the avoidance of labour standards through letterbox companies in the international transport sector in the 1990s. At that time, companies started cutting costs by registering letterbox companies as employers in countries that had low wage and social security levels whilst drivers worked in jurisdictions with higher levels of labour protection (Hastings and Cremers 2017). Investigations show that letterbox companies are used to circumvent the Posting of Workers Directive and the Road Transport Regulation for the purpose of minimising responsibilities under labour law (ETF 2012). Case studies of regulatory avoidance ranging from evasion of social contribution to downright exploitation and human trafficking highlight the urgency of the situation (Sanz de Miguel *et al.* 2017).

The large number of letterbox arrangements used for corporate regime shopping is enabled by the European Commission's and Member States' deregulation agenda that was instituted alongside the EU's internal market freedoms. This policy brief provides a definition of letterbox companies and, drawing on two case studies, shows how they are used to avoid labour standards and taxation. It concludes with a number of recommendations for combatting regulatory avoidance through letterbox companies.

1 This policy brief is based on work undertaken by Katrin McGauran at SOMO.

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Definition of letterbox companies

The precise characteristics of letterbox companies depend on the type of regulation that is avoided or the kind of legal protection that is sought. For instance, a letterbox used for tax avoidance is typically foreign-owned and channels funds between subsidiaries within the same group. This is because tax avoidance makes use of legal loopholes or mismatches in domestic laws, as well as tax treaty networks that offer low withholding tax rates on outgoing payments from countries of operation. Anti-tax avoidance and evasion measures sometimes refer to letterbox companies set up in tax havens as Controlled Foreign Corporations (CFCs), which are defined as 'non-resident affiliates to which [corporate groups] shift income […] established wholly or partly for tax reasons rather than for non-tax business reasons' (OECD 2015).

Letterbox companies do not necessarily have to be set up in different jurisdictions to avoid regulation and liabilities. Employers can use a web of domestic letterbox companies (i.e. letterbox companies in one jurisdiction) to obscure liability and avoid labour standards. Domestic or foreign-owned letterboxes can be used as an employing agency that signs contracts with workers, often not longer than six months under one letterbox. These workers do not build up entitlements and are left either without recourse to courts when wages remain unpaid (in case of bankruptcy) or practically impossible recourse when the formal employer is incorporated abroad. These companies can be dissolved or 'bankrupted' to avoid payment of due wages or fines when inspections by authorities indicate irregularities or fraud (Meissnitzer 2015; FATF and OECD 2010). Liability towards the state or employees is thus avoided by hiding ultimate beneficial owners (and employers) behind the corporate veil.

For a conceptual understanding, it can be said that, despite a certain amount of variance in how letterbox companies are used, shared characteristics can be seen across different sectors. These are threefold:
1. They are 'artificial arrangements', i.e. the legal reality of an incorporated entity claiming to engage in a specific economic activity does not reflect the material reality.
2. Trust and company service providers (TCSPs) and legal advice (tax, payroll, accountancy) are used to advise on 'artificial constructions' to ensure regulatory compliance with domestic company law, to symbolically fulfil any 'substance' requirements (i.e. requirements for real activity) and to adapt to any changes in regulations.
3. Ownership relations can be obscured through trustee services or proxy ownership.

The lack of a practical definition in national, international (treaty) law or case law is a serious problem for enforcement (Hastings and Cremers 2017). In the 2006 *Cadbury Schweppes* and subsequent European Court of Justice (ECJ) decisions, the ECJ ruled that '…a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned' (paragraphs 51 and 55 of *Cadbury Schweppes and Cadbury Schweppes Overseas*, Case C196/04 [2006]). This principle was subsequently referred to in a number of ECJ decisions (e.g. C524/04 [2007], C330/07 [2008] and C182/08 [2009]).

In other decisions, famously the 1999 *Centros* decision (C-212/97) and recently the 2017 *Polbud–Wykonawstwo* case (C-106/16), the ECJ ruled in favour of the right of companies to move their place of registration to another country, even if the legal entity does not reflect commercial reality and the move is motivated by more favourable legislation. Allowing such corporate transfers without economic substance has impacts on corporate governance, such as enabling circumvention of mandatory board-level participation rules and fair taxation. Whilst acknowledging the policy space for Member States to curb abuse, the ECJ decisions thus also act as a barrier to enforcement. Without a legal definition, adjudicating on 'wholly artificial arrangements' will remain difficult, as judges require specific criteria in ruling on disputes. Furthermore, internal market freedoms receive more weight in ECJ decisions than workers' rights and the rights of Members States to protect their social systems.

The use of letterbox companies to avoid or abuse laws and regulations

This section provides two examples of how letterbox companies exploit loopholes to avoid regulations. The first case study, on Vos Transport in the road transport sector, illustrates the avoidance of labour laws. The second example, based on Eldorado Gold, shows how tax obligations can be reduced with letterbox companies.

Transport sector: avoiding minimum wages and collective labour agreements (CLAs)

In the European context, letterbox companies are often used to abuse the Posting of Workers Directive (Directive 96/71/EC) (here referred to as 'PWD') and related Enforcement Directive. Under this legislation, exceptions are defined to the *lex loci laboris* principle, under which workers are subject to the social security system, pay and conditions of employment where the work is performed. Significantly, workers may be paid for a period of up to six months based on rules from their 'country or origin' rather than in the country they are actually working in. Companies in high-wage countries can save a significant amount of money by recruiting workers from low-wage countries for a maximum period of six months. After this period workers are supposed to be paid according to the rules of the country of employment.

However, companies have found different ways to avoid this requirement, and trade unions in the transport and construction sectors have uncovered large-scale abuse of the PWD. In a Dutch case investigated by Stichting VNB, a foundation of the trade union umbrella FNV (McGauran 2016), half of the journeys by the transport company Vos Transport BV were found to be carried out by Romanian and Lithuanian employees under contract of Romanian and Lithuanian subsidiaries of the Dutch company. These employees were paid and employed according to Romanian and Lithuanian rather than Dutch rules, despite the fact that the drivers were working in the Netherlands. According to trade union research, the Romanian subsidiary did not show any evidence of substantial operations in Romania and its managers were Dutch. Vos Transport's ultimate parent, Reje BV, reported a 15 per cent increase of staff employed abroad between 2011 and 2015, indicating a business model of outsourcing work to foreign drivers.

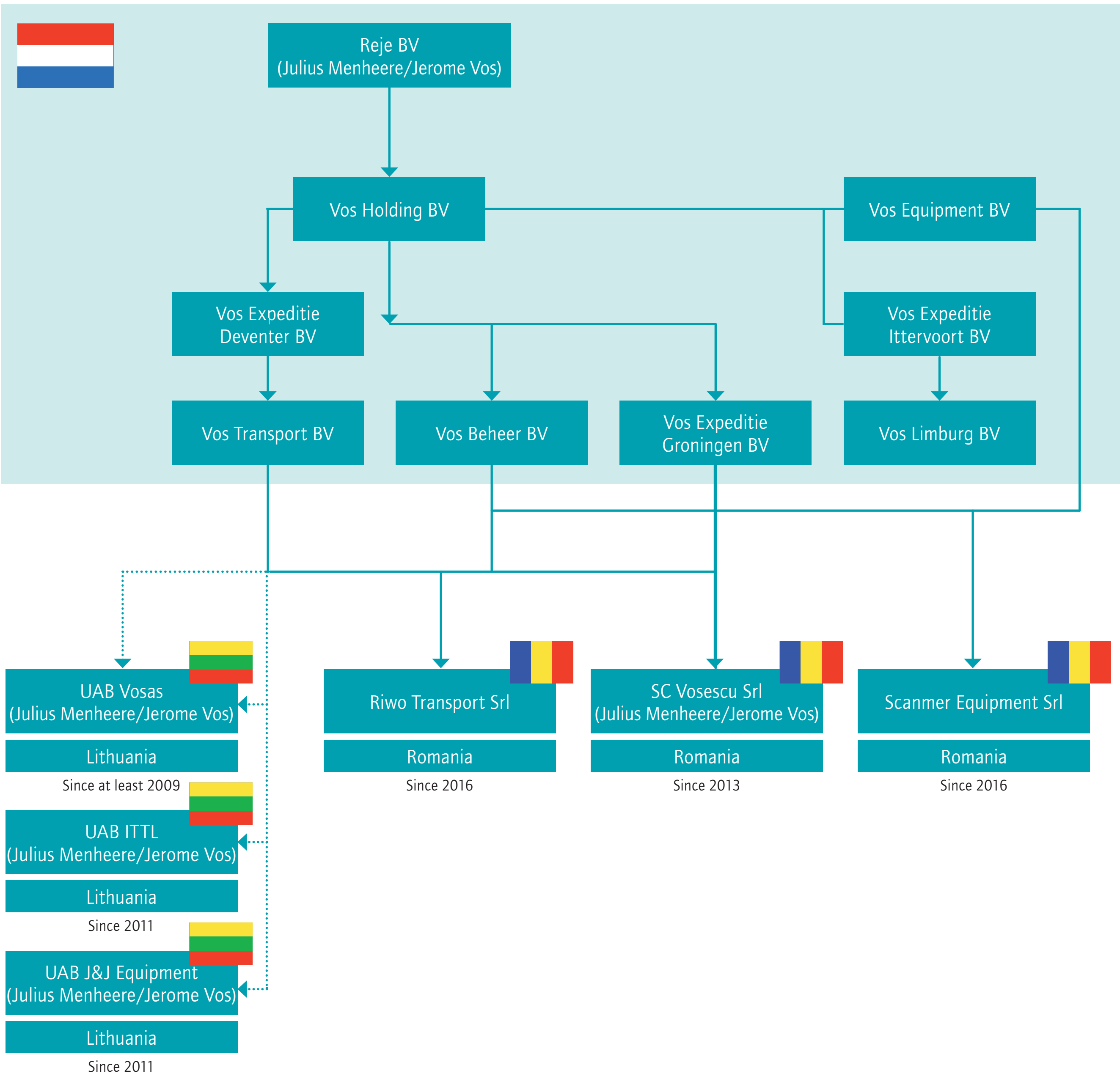
In 2016, Vos Transport had three Lithuanian and three Romanian subsidiaries. These were controlled by Jerome Vos, director of operations, and Jules Menheere, general manager at Vos Transport B.V. in the Netherlands. Trade unionists visited the addresses of the two Romanian companies. They found that one of the companies was located in a private house and the other was located at an address without an actual house or office building. All eastern European subsidiaries were also under the management of directors or managers of the Dutch parent company Transport BV and the drivers could show they were managed from within the Netherlands.

The drivers contracted under Vos Transport's Romanian subsidiary had a wage of about €200 a month (excluding reimbursement for housing and bonuses for maximum driving hours). Working conditions stipulated under the CLA were also not respected, such as the length and number of consecutive working days, and resting in the truck, which is forbidden under Dutch labour law.

ECJ case law, confirmed by the Dutch courts, stipulates that the labour law of that country in which the drivers work should apply. Furthermore, if a CLA (such as the Dutch Transport CLA) is generally applicable, a posted worker should be covered by that CLA's minimum wage.

This case illustrates how the use of legal entities in low-pay, -contribution or -regulation jurisdictions are used to abuse the original intention of short-term postings to create permanent cost-saving business models.

Figure 1 **Vos Transport corporate structure**



Source: Orbis, Dutch Chamber of Commerce, extracted August 2016 (ETUC and SOMO 2016).

Letterbox companies and corporate income tax avoidance – an example from the mining sector

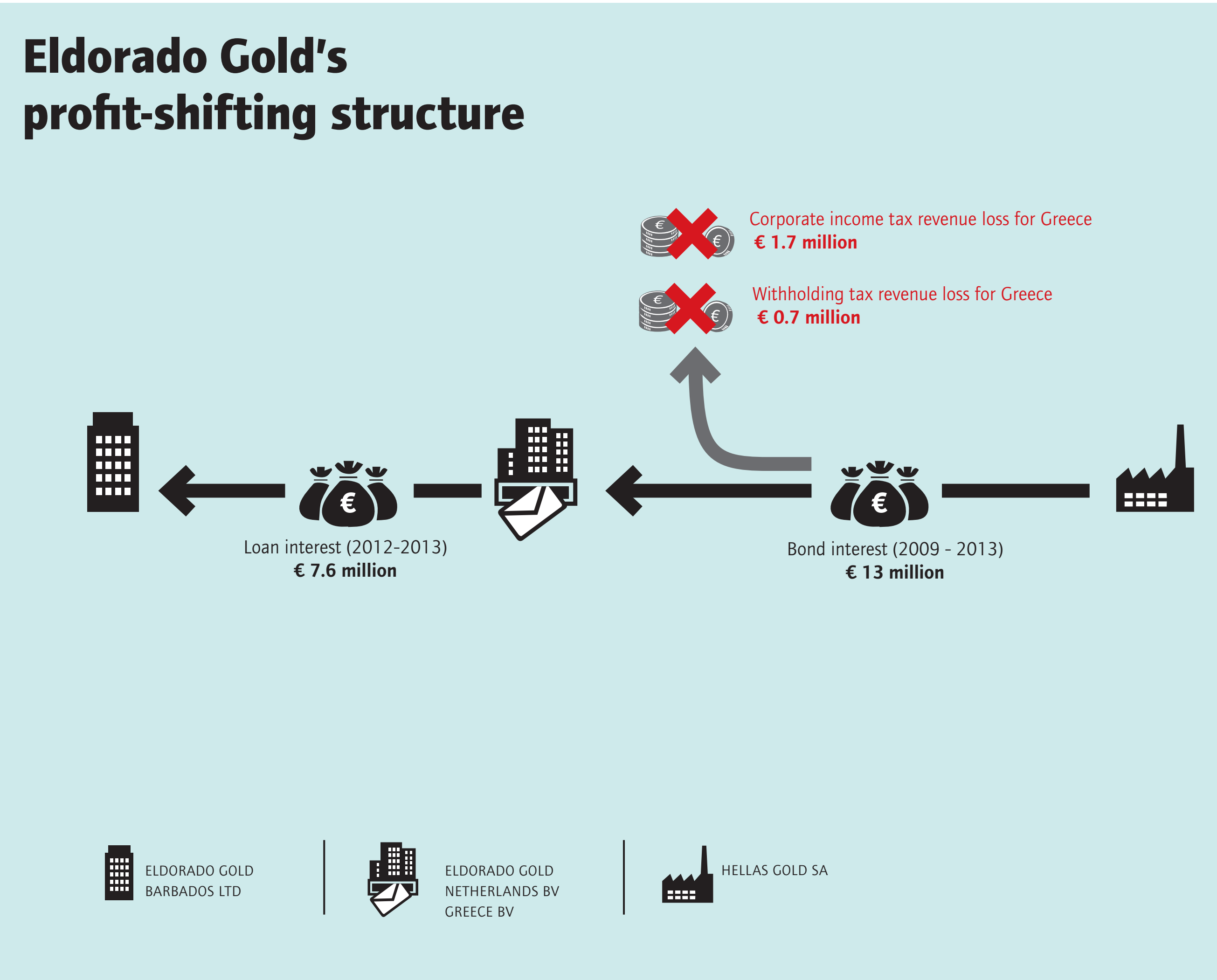
Letterbox companies can also be used to reduce companies' tax bills by shifting income from a subsidiary with economic activities in one tax jurisdiction to an empty shell subsidiary in a lower tax jurisdiction. Costs are created or inflated in operational subsidiaries, which reduces the company's profit in the higher tax country, and the corresponding income is shifted to the subsidiary in the lower tax country, which reduces overall corporate income taxes paid by the company group. Loan financing is a common profit shifting mechanism, illustrated here by the case of the Canadian mining company Eldorado Gold (McGauran *et al.* 2015).

Eldorado Gold began setting up an elaborate intra-company lending scheme between its gold mining activities in Greece, letterbox companies in the Netherlands, and a letterbox company in the tax haven of Barbados in 2012. Even after exposure in the media in 2016, this arrangement continued until the end of the loan term in late 2018.

The Greek-based subsidiary Hellas Gold finances its operations by issuing bonds that are bought up entirely by its Dutch letterbox subsidiaries. The Dutch companies in turn are financed by loans from Eldorado Gold's Barbados-based letterbox subsidiary. Interest payments on the bonds and loans, which shift from Greece to the Netherlands and then to Barbados, remain virtually untaxed at the level of the corporate group. This Dutch financing structure – rather than direct financing by the Canadian parent company – has saved Eldorado Gold (and cost the Greek government) more than €700,000 in withholding taxes in two years and €1.7 million in corporate income taxes in five years.

Enabling such practices are low substance requirements (i.e. requirements for real economic activity) in the Netherlands, which allow foreign companies to use corporate service providers to set up letterboxes to take advantage of a combination of tax laws. These advantageous provisions include: favourable tax treaties, the participation exemption (where profits from foreign subsidiaries remained untaxed), fiscal unity (which allows profits and losses to be offset within the same corporate group in the Netherlands), and a lack of withholding taxes on outgoing payments to tax havens.

Figure 2 **Dutch conduit structure**



Source: McGauran *et al.* 2015.

Conclusions and policy recommendations

The above cases show how letterbox companies are used by companies and employers to avoid taxes, social security and labour standards. In the case of labour standards, the problem lies in the obfuscation by employers of actual or direct employment relationships, which should generate employer liabilities and lead to a build-up of entitlements. Strategies involve bogus postings, facilitated by recruitment, subcontracting, and false self-employment. In tax cases, profit is typically shifted via conduit companies to tax havens through a series of letterbox companies. Policy measures that could help combat these practices include: introducing liability for a group of companies (including the supply chain), requiring full transparency, and introducing an EU-wide substance requirement for company activity.

Group liability

The separate legal personality and limited liability principles granted in corporate law worldwide allow constituent parts of the same corporation to operate as independent legal persons, even though they have the same ultimate ('beneficial') owner. To counter such avoidance of liability, the Commission should explore possibilities – based on existing proposals in human rights law (see e.g. Blumberg 1986 or Muchlinski 2010) for *new legislation recognising the corporate group as one liable entity in law.* This would ensure legal liability for fraudulent activities at group (and ultimate beneficial ownership) level rather than at the subsidiary level.

Corporate law of EU Member States already permits victims of human rights and environmental abuses committed by third-country subsidiaries in exceptional circumstances to obtain redress from the European (parent) corporation (Augenstein 2010). The exceptions to the principle of separate legal personality (sometimes referred to as 'piercing the corporate veil') should be extended to include not only severe human rights violations but proven violations of labour, social security and tax laws committed by subsidiaries. Especially since the 2009 Lisbon Treaty gave the EU Charter of Fundamental Rights, including workers' rights, binding legal force within the EU.

Furthermore, there is currently no European mechanism of 'joint and several liability' with regard to subcontracting. This would allow workers to claim compensation or unpaid wages against any one party in the subcontracting chain as if they were jointly liable, making it the responsibility of the parties in the chain - and not the worker - to sort out their respective proportions of liability and payment. In order to tackle subcontracting chains using letterbox companies and discourage deliberate evasion of liabilities, the Commission *should create comprehensive legislation to regulate liability in subcontracting processes*. This could be done by making existing chain liability provisions for specific sectors and situations generally applicable (e.g. 2014/67/EU, 2009/52/EC).

Transparency

Ownership and financial transparency are crucial if regulatory avoidance is to be tackled effectively. An important step towards transparency was made with the adoption of the 5th EU Anti-Money Laundering Directive, which introduces beneficial ownership registries for companies and some trusts.

However, to enable Member States (including labour, tax, and fraud inspectorates) and civil society (including investigative journalists, transparency and tax justice groups, trade unions) to actively and effectively identify fraudulent practices and owners of companies, the Commission should propose:

- A central European business registry providing European companies with unique legal identification numbers
- A European system for identifying disqualified directors (i.e. persons who have been ruled to be ineligible to serve as company directors in a Member State), but also companies that have committed serious violations of social and tax legislation.
- Stronger supervision and enforcement of tax fraud and money-laundering and investigating the feasibility of creating a European anti-money laundering authority to enforce the 5th EU Anti-Money Laundering Directive directly.

Member States need to:

- Swiftly implement public registers of beneficial owners for companies and trusts as foreseen by the 5th EU Anti-Money Laundering Directive and make access free of charge and in an open-data format.
- All public interest entities and all large companies (i.e. companies with turnover of €40 million, which is in line with the existing EU definition of large undertakings) should report, amongst others, turnover, number of employees (in full time equivalents), assets, capital, sales, purchases, profit or loss before tax, tax paid and accrued; furthermore, a full list of all subsidiaries in each EU member State or third country, including name(s), nature of activities, geographical location, by country should be published without exceptions (Eurodad 2017).

Comprehensive and coherent EU definition of genuine economic activity

With a view to creating a comprehensive and coherent EU framework to protect social and fiscal policy objectives from artificial corporate avoidance structures, the Commission *should publish an overview of existing definitions of genuine economic activity as well as anti-abuse provisions* in national and EU law in all policy areas.

Furthermore, the Commission *should make an impact assessment of these provisions*, using examples from Member State and EU definitions and cases, with regard to their effectiveness in detecting and ending regime shopping and regulatory avoidance through artificial corporate structures.

On the basis of such an impact assessment, the Commission *should propose a definition* in a legal framework clarifying the EU's body of common rights and obligations in all policy areas. If an assessment finds detailed definitions of genuine activity effective, these might differ per economic sector in terms of substantive criteria and scope. This should be accompanied by a practical policy guide across legal areas for competent institutions, such as labour and tax authorities.

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