

INT-AR Paper 9 – Cross-border recruitment and artificial arrangements – Jan Cremers (UvT)**Artificial legal corporate entities and the recruitment of labour**

This paper aims to give an overview of the state of the art with regard to the scientific and empirical knowledge on ‘letterbox companies’. The broad spectrum of practices that can be associated with the notion of letterbox companies has led to fact-finding, evidence based research and other scientific work from the angle of different disciplines (law, sociology, economics and political sciences). Even inside these disciplines the analysis can have different angles, for instance from the perspective of tax law, corporate law or labour law. This multidisciplinary paper informs about the (possible) relationship between letterbox companies and practices that seem ‘perfectly legal’, but can be, not only from a moral point of view, dubious or unlawful.

The notion of letterbox companies was originally mainly used in the field of taxation and associated with (the evasion of) corporate and income tax.¹ The use of this type of artificial corporate entities was assisted and promoted by trusts and company and legal services (often also the ‘incubators’ of the arrangements) that provided ‘substance’ and regulatory compliance. These services earned substantial sums from facilitating transactions for tax evasion and money laundering. The EU has reacted in the last ten years with discussions on the matter at the European Council.² The European Commission formulated several proposals for action against tax heavens and tax evasion (for example, the ‘country by country reporting’). Also the European parliament became very active in this field.³

In the labour and social security policy areas the notion came up in the late 1990s in the international transport sector, based on dubious practices and problems caused by letterbox companies, which had only addresses in the country of establishment and all activities offshored to a different jurisdiction, often combined with ‘bogus self-employment’ among drivers and ignorance of statutory pay and working time.⁴ It was reintroduced at EU-level during the preparations of the Services Directive (2004) and in the debates about the necessity to promote decent work. The phenomenon became associated with a ‘cheap labour business model’: letterbox companies that operate in a cross-border context and pick and choose the social security and labour standards regime that is the most profitable. Ownership and employer liabilities are obscured or blurred by using proxy owners or henchmen. These entities take advantage of limited inspection competences and a lack of transnational enforcement mechanisms to deprive workers of their wages and contributions.⁵ In practice the cross-border recruitment prevents states from reinforcing employment and labour standards, or their circumvention through fake ownership and questionable labour relations.⁶

Different perspectives – different definitions

Over the years more specialists from several disciplines started to examine and analyse the notion of letterbox companies. This resulted in different definitions depending on the perspective that was chosen. The OECD provided one of the most commonly used definitions in its Model Tax Convention 2014, whereby a letterbox company is a paper company, shell company or money box company, i.e. a company which has compiled only with the bare essentials for organisation and registration in a particular country, whilst the actual commercial activities are carried out in another country.⁷ This definition refers in case of tax evasion to a business that establishes its domicile in a tax friendly country with just a mailing address while conducting its commercial activities in other countries for purposes of minimising its tax liability. The European Commission reasons in the same direction by stating that ‘letterbox subsidiaries’ are artificial arrangements established in countries solely to qualify for a softer tax regime and cut their bill.⁸

The linkage with the free provision of services led, some 15 years ago, to a definition that went beyond taxation. In the debates, critics of the uncontrolled mobility of national service providers referred to the creation of letterbox companies offering services at low prices, which would be able to operate from their registered offices across the whole territory of the EU. The consequence, it was feared, would be enormous pressure on countries with social, fiscal and environmental standards that protect the general interest.⁹

Interestingly, the European Commission referred in 2013 to legislative loopholes with a definition that said 'letterbox companies are companies which have been set up with the purpose of benefitting from legislative loopholes while not themselves providing any service to clients'.¹⁰

On a special website, targeting the abusive use of letterbox companies, the definition talks about a firm that is set up with the intention of circumventing legal and conventional obligations (taxation, social security, VAT, pay and pay related working conditions). The companies do not actually perform any real economic activities although claiming to do so.¹¹ In a recent study, commissioned by the ETUC, the definition focuses on a range of issues: a letterbox company is defined as a business that establishes its domicile in a given Member State while conducting its (substantial) activities in other Member States for purposes of circumventing or evading applicable legal obligations (lower taxes, wages, labour standards and social security contributions).¹²

Mobility and freedom of establishment

The establishment of a company or subsidiary is covered in the EU by the freedom of establishment, as enshrined in Article 49 TFEU. Thus, in general terms, setting up a letterbox company in a foreign constituency is facilitated by that provision. Besides, companies benefit from the internal market principles that guarantee both the right of establishment and the freedom to provide services, cf. Articles 54 and 62 TFEU.¹³ Corporate entities are creatures of national law and the rules for setting up companies vary significantly among Member States. Some Member States traditionally follow the so-called real seat theory; the law governing a company is determined by the place where the central administration and substantial activities of that company are located. This requires companies having their operational headquarter within a given Member State to be established under the laws of that state. Other Member States follow the incorporation theory, which favours party autonomy in the choice of corporate law. Hence, under such law, companies may have their 'real seat' in a Member State different from the state of incorporation, which also implies that they may have a mere letterbox in the incorporation country. Companies can thus install a considerable part of their legal frameworks in other EU Member States without pursuing any activities there. Based on the freedom of establishment and the free provision of services these national entities are free to move around and get market access elsewhere in Europe. In theory, the requirement can be imposed that companies with their seat situated inside the EU can only exercise the right of establishment and the freedom to provide services if their activity shows a real and continuous link with the economy of a Member State. The potential implication is that letterbox companies formed without any activities in the EU can neither rely completely on the right of establishment nor on the freedom to provide services. But inside the EU, the conflict of legal provisions in labour law and company law can be used by companies which create artificial arrangements for the purpose of evading statutory and other obligations in the country of activity.

A report (from September 2016) of the European Parliament, dedicated to social dumping practices, asked to put an end to the letterbox companies by ensuring that businesses registered in EU Member States are genuine and active ones.¹⁴ The report suggested to tackle the phenomenon by the creation of an EU-wide list of enterprises, including letterbox companies, responsible for serious breaches of European labour and social legislation to be drawn up – after they have received prior warning – which can be consulted only by the relevant inspection authorities. However, national laws determine the way business registers are organised and the legal value of entries. The EU Council of Ministers so far has refused to work towards a central business register. A less far-reaching alternative is developed in Directive 2012/17/EU, which establishes a system of interconnection of business registers. It is currently being implemented and will be operational by mid-2017.

The notion of the genuine undertaking

Throughout the EU acquis, just a few conditions are formulated that could define the genuine undertaking. There is neither a unified integral and horizontal definition at EU-level, nor a comparable definition across Member States, nor a definition in identical terms in the different policy areas at national and European level. The most important notions are:

- in the field of taxation, the European Commission tabled changes in the Parent Subsidiary Directive, including a general anti-abuse rule, but this was restricted to tax transfers. The Directive says that Member States' tax administrations, when assessing whether an arrangement or a series of arrangements are abusive, should undertake an objective analysis of all relevant facts and circumstances; an arrangement or a series of

arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

- the Regulations for the coordination of the social security (883/2004 and 2009/987) provide criteria for the assessment of the genuine character of an undertaking; Regulation 987/2009 Art 14. 2 says:

For the purposes of the application of Article 12(1) of the basic Regulation, the words 'which normally carries out its activities there' shall refer to an employer that ordinarily performs substantial activities, other than purely internal management activities, in the territory of the Member State in which it is established, taking account of all criteria characterising the activities carried out by the undertaking in question. The relevant criteria must be suited to the specific characteristics of each employer and the real nature of the activities carried out.

- the Regulation for the international transport (1071/2009) formulates criteria on access to the sector, with provisions to eliminate letterbox firms; for instance Article 3 prescribes that undertakings engaged in the occupation of road transport operator shall have an effective and stable establishment in a Member State; and Article 5 provides a list of conditions relating to the requirement of establishment:

In order to satisfy the requirement laid down in Article 3(1)(a), an undertaking shall, in the Member State concerned:
(a) have an establishment situated in that Member State with premises in which it keeps its core business documents, in particular its accounting documents, personnel management documents, documents containing data relating to driving time and rest and any other document to which the competent authority must have access in order to verify compliance with the conditions laid down in this Regulation. Member States may require that establishments on their territory also have other documents available at their premises at any time;

(b) once an authorisation is granted, have at its disposal one or more vehicles which are registered or otherwise put into circulation in conformity with the legislation of that Member State, whether those vehicles are wholly owned or, for example, held under a hire-purchase agreement or a hire or leasing contract;

(c) conduct effectively and continuously with the necessary administrative equipment its operations concerning the vehicles mentioned in point (b) and with the appropriate technical equipment and facilities at an operating centre situated in that Member State.

- the Enforcement Directive (2014/67/EU) for the posting of workers gives some guidelines in Article 4.2:

In order to determine whether an undertaking genuinely performs substantial activities, other than purely internal management and/or administrative activities, the competent authorities shall make an overall assessment of all factual elements characterising those activities...

Such elements may include in particular:

(a) the place where the undertaking has its registered office and administration, uses office space, pays taxes and social security contributions and, where applicable, in accordance with national law has a professional licence or is registered with the chambers of commerce or professional bodies;

(b) the place where posted workers are recruited and from which they are posted;

(c) the law applicable to the contracts concluded by the undertaking with its workers, on the one hand, and with its clients, on the other;

(d) the place where the undertaking performs its substantial business activity and where it employs administrative staff;

(e) the number of contracts performed and/or the size of the turnover realised in the Member State of establishment, taking into account the specific situation of, inter alia, newly established undertakings and SMEs.

Case law on artificial arrangements

In one case concerning VAT tax, the Court of Justice of the European Union stated that it may become apparent that sometimes certain contractual terms do not wholly reflect the economic and commercial reality of the transactions. That is the case in particular if those contractual terms constitute a purely artificial arrangement which does not correspond with the economic and commercial reality of the transactions.¹⁵

However, the settled CJEU case-law with regard to domestic measures targeting letterbox companies established in other Member States is more important. Measures that are likely 'to limit their freedom of establishment or their freedom to provide services' are not per se incompatible with EU law, but have to be justified by overriding reasons of public interest. And restrictions must be appropriate to attain the objective pursued and cannot go beyond what is necessary.¹⁶ The overriding reasons of public interests, considered by the CJEU, are mostly limited to the prevention of abusive tax practices, for instance in case of 'wholly artificial arrangements intended to escape the domestic tax normally payable'.¹⁷ According to the CJEU, the finding that there is a wholly artificial arrangement must be based on objective factors which are ascertainable

by third parties with regard, in particular, to the extent to which the controlled foreign company physically exists in terms of premises, staff and equipment. If checking these factors leads to the finding that the company is ‘a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State’, the creation of that company must be regarded as having the characteristics of an artificial arrangement. The CJEU adds that this could be so in particular in the case of a ‘letterbox’ or ‘front subsidiary’.¹⁸

Moreover, the CJEU has ruled that a host state may not refuse recognition of the legal capacity of a company incorporated under the law of another Member State, even if the company does not pursue any economic activity in the latter state. This was the start of a process of regulatory competition in the EU as, afterwards national reforms moved away from the real seat theory in laws governing the creation of companies. There is a clear lack of coherence regarding the choice of law rules in current EU regulations on the activities of supranational companies and the cross-border provision of services. In the end, the CJEU requires not only the elimination of all discrimination on grounds of nationality against providers of services established in another Member State, but also ‘the abolition of any restriction, even if it applies to national providers of services’. This policy has eased the possibility for letterbox companies to be created through artificial arrangements in order to circumvent national mandatory rules and obligations.¹⁹

The impact of artificial arrangements

The impact of letterbox companies on compliance with and respect for labour standards and social security obligations is only scarcely investigated. Besides, the primacy to freedom of establishment and deregulation of company law that dominates the internal market can make letterbox-type practices legal under EU law. This creates serious tensions with the enforcement of labour, social security and tax laws.²⁰

- In the field of *taxation*, the regulatory context can be characterised by a lack of harmonisation as regards corporate and personal income taxes. The EU has restricted competences and each Member State has in principle the power to determine which companies are tax resident in that state. The EU Treaty provides for tax provisions which aim at removing obstacles to intra-EU trade that result from the exercise of taxation powers by Member States. It is possible to prohibit Member States to establish or maintain obstacles to intra-Community movement and trade.
- In the field of *social security*, the EU has limited competences; form and content of the social security schemes belong to the competences of each Member State. The coordination of the different national schemes is based on the principle of application of one legislation at a time in cases of employment being executed in one or more than one Member State. Persons moving within the EU are subject to the social security scheme of only one Member State. The coordination generated a substantial amount of jurisprudence, notably linked to the free movement and cross-border recruitment.
- At the start of the internal market project, there was ambiguity with regard to the applicable *wages and working conditions* of workers posted abroad in the context of temporary service provision. No unified regulatory framework made national labour standards mandatory for all workers and there were hardly any binding provisions in the Member States. Several countries exempted temporarily posted foreign workers from the application of the national standards. The enactment of the Posted Workers Directive aimed to fill the gap. However, problems emerged as the relationship was underscored between the working conditions of posted workers involved in temporary cross-border activities and the free provision of services. The internal market thus interfered directly with national social policies and the *lex loci laboris* principle came under pressure.²¹

By the late 1980s, first indications of the practice of bypassing the applicable rules through the use of foreign labour-only subcontractors led to questions about the possible relationship between cross-border labour recruitment and artificial arrangements. The free provision of services by foreign entities resulted in exemption from the host land social security legislation, questionable practices in the field of income and corporate tax and the watering down of national labour standards, mandatory pay and working conditions. Thus, for instance, posting of workers could become part of a matrix of complex, semi-legal and outright unlawful employment arrangements involving foreign corporate entities with no or questionable substance in the country of establishment. The absence of genuine activities in the country of origin was combined with

repeated cross-border work, in other Member States on an almost permanent basis. Letterbox companies were (and are) opened for the purpose of recruiting workers for work abroad. These workers often act under the direct supervision of the user undertaking, creating a situation of blurred labour relations or illicit provision of manpower.

The regulatory framework related to the phenomenon of artificial arrangements is stretched over various national and EU policy areas, with non-coherent, contradictory or even conflicting rules in company, labour and contract law, internal market regulations, tax rulings and social security legislation. Silo-thinking and a lack of cooperation across disciplines leads to the application of different notions about lawfulness, regularity and the genuine character of activities and entities. Competences to verify the genuine character of the activities are fragmented and spread over different national institutions. The dispersion and fragmentation of the competence to control and enforce make it difficult to monitor and combat abusive practices and the patchwork of regulations, combined with a lack of enhanced and straightforward cooperation beyond the limits of every separate policy area or discipline, hinders effective actions of inspections and enforcement services. Moreover, legal complexity and loopholes hamper effective application of the law and therefore favour unreliable actors. Unnecessary frictions between these areas of law should be avoided where prevention and combating letterbox companies require a consistent enforcement frame.

The signalled loopholes paved the way for firms and agencies that can be easily, and at low cost, established as a legal entity in a foreign constituency, disappear across the border, go bankrupt and start all over again. It also led to an advisory industry of incubators that can explain how ‘perfectly legal’ the course of action is. It is imperative to strengthen the legal framework and to repair loopholes and inconsistencies in a horizontal and coherent way. This in fact, asks for an impact assessment across a large part of the internal market acquis, not only with the aim to protect workers, but also in the interest of genuine economic actors and customers.

¹ The notion of letterbox companies is used here for a company that has no or very little activity at the place where it is registered.

² During the debate about amendments of the Parent-Subsidiary Directive, letterbox companies were discussed as artificial arrangements that serve to reduce the tax bill involving profit distributions/dividend payments between a parent company in one Member State and a subsidiary in another. http://europa.eu/rapid/press-release_MEMO-13-1040_en.htm

³ This ‘fiscal engineering’ is the area mostly covered by the media (the Panama papers et cetera). Also the EU institutions look primarily at this area, see: <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-205>
http://www.akeuropa.eu/en/european-parliament-debates-letterbox-companies.html?cmp_id=7&news_id=3015&vID=41

⁴ E.g. the Kralowetz-affair that ended with prison sentences: <http://paperjam.lu/communiqu/affaire-kralowetz-reaction-du-ministere-des-transport>

⁵ C-V. Martin, Preventing illegal immigration: juggling economic imperatives, political risks and individual rights, 2004, Council of Europe, Strasbourg. J. Cremers, The free movement of workers in the European Union, 2004, Brussels, CLR/Reed Business Information. J. Cremers, In search of cheap labour, 2009, Brussels, CLR/i-books.

⁶ The Dutch EU-presidency organised a conference (in the spring 2016) with inspection services and other controlling institutions from the Member States. Part of the agenda was dedicated to letterbox practices: <https://www.inspectieszw.nl/decentwork/>

⁷ Also listed in the OECD-glossary of tax terms: <http://www.oecd.org/ctp/glossaryoftaxterms.htm#L>

⁸ European Commission, MEMO, Questions and Answers on the Parent Subsidiary Directive, 2013, http://europa.eu/rapid/press-release_MEMO-13-1040_en.htm?locale=en

⁹ <https://www.eurofound.europa.eu/observatories/eurwork/articles/unions-protest-against-draft-eu-services-directive>

¹⁰ http://ec.europa.eu/smart-regulation/better_regulation/documents/1_en_act_part1_v4.pdf

¹¹ <http://www.stopletterboxcompanies.eu/>

¹² <https://www.somo.nl/wp-content/uploads/2016/10/ETUC-report-annex-1.pdf>

¹³ For a more detailed explanation see: <http://www.caymanfinancialreview.com/2016/01/28/letterbox-companies-in-the-eu/>

¹⁴ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2016-0346+0+DOC+XML+V0//EN>

¹⁵ <http://curia.europa.eu/juris/document/document.jsf?docid=138694&doclang=EN>

¹⁶ http://www.ab.gov.tr/tarama/tarama_files/03/SC03EXP_Right_of_Establishments.pdf

¹⁷ Case C: 2008 :239 <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62005CO0201>

¹⁸ ECJ 15.3.2011, C-29/10, Koelzsch, ECR 2011 p. I-1595, ECLI:EU:C:2011:151.

¹⁹ K. Lenaerts, Self-employed and Europe: Small businesses and the freedom to provide services, 2011, European Journal of Law.

²⁰ Ibid note 11. Also M. Bernaciak, 2015, Market Expansion and Social Dumping in Europe, Routledge, London.

²¹ Economic freedoms and labour standards in the European Union, J. Cremers, 2016, Transfer 1-14