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The fight against letterbox companies in the internal market

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After the seminal judgement in Centros, it seemed that the fight against letterbox companies was lost. The judgement made it clear that it is possible for a company without any substantial activities in the Member State where it is incorporated to exercise the free movement rights when doing business in other Member States. After this judgement, the widespread use of letterbox companies was not encountered by any coordinated effort of the EU, and instead the Member States individually undertook the fight of letterbox companies. However, it is clear that the letterbox companies sometimes interfere with the proper functioning of the internal market. As a result, the EU has recently either adopted or proposed legislation aiming at diminishing the threat of letterbox companies. The article analyses these legislative measures, their backdrop and their impact.

1. Letterbox companies in the internal market

Both in press and legal literature there are often references to letterbox companies. Sometimes different names are used such as mailbox companies, brass-plate companies, shell companies or pro forma-companies. None of these terms have an explicit meaning but all seem broadly to refer to the same phenomenon: a company which has no or very little activity at the place where it is registered.¹ These companies are often associated with activities that are, if not criminal, then at least dubious. If letterbox companies are used to either avoid paying taxes in the Member State where they are due or if they are used to avoid legislation in a Member State, they may undermine the functioning of the internal market.

Until recently, EU law has been very tolerant towards letterbox companies and may even be said to facilitate their use. However, in recent years there have been several examples where the EU through secondary legislation has addressed letterbox companies with the aim of restricting their use. This development will be examined in this article. First, the more traditional approach to letterbox companies will be analysed. In section 2 the freedom of establishment and freedom to provide services as it applies to letterbox companies will be examined followed by an analysis of how letterbox companies have been handled in the harmonisation of company law in the EU (section 3). Then section 4 explains the more recent initiatives aiming to limit the use of letterbox companies, and finally section 5 analyses the different approaches to regulating letterbox companies with the aim of evaluating their potential. Section 6 sums up.

¹ Shelf companies on the other hand refers to a less dubious occurrence where companies are formed without any specific activity in mind and are later sold to business entrepreneurs who need to incorporate quickly. The fact that it is often possible to incorporate quickly on-line today, means that the use of shelf companies has declined in many jurisdictions.

Strictly speaking the problem with letterbox companies is not restricted to companies as it may also be limited partnerships, trusts and other forms of businesses that are used in this way. However, it seems that companies are most often used for this kind of activity, and among the corporate forms private limited companies seems to be preferred over others due to the fact that these are relatively cheap to form (low or no minimum capital requirement) and the fact that they provide for limited liability and maybe the possibility to stay anonymous as shareholder.² For this reason the term letterbox companies and the focus on companies are maintained in this article.

The article focuses on the problems which letterbox companies cause in the EU, but it is obvious that the problem also occurs in a broader international context. In relation to certain types of crime, the problem may even be greater in relation to companies established outside the scope of the EU. Focus of this article is, however, the initiatives taken in relation to letterbox companies within the scope of the EU.

2. Letterbox companies and free movement in the internal market

To explain how letterbox companies may benefit from the internal market, a distinction should be made between, on the one hand, how setting up a letterbox company may be protected by the freedom of establishment and, on the other hand, how letterbox companies, once they are formed, may benefit from the free movement rights, especially the freedom of establishment and the freedom to provide services.

2.1. Setting up a letterbox company

According to Article 49 TFEU establishing a subsidiary is covered by the freedom of establishment. Therefore, it would seem that setting up a letterbox company would be protected by that provision. That, however, is only the case if the setting up of a company qualifies as an establishment. If the company is formed without any activities or without the intention of have any activities, then there is no establishment and consequently the formation would fall outside the protection of Article 49.

The Court of Justice of the European Union (the Court) has defined the concept of establishment in several cases. In Case C-55/94, *Gebhard*, para. 25, the Court gave the following definition of an establishment: 'The concept of establishment within the meaning of the Treaty is therefore a very broad one, allowing a Community national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to economic and social interpenetration within the Community in the sphere of activities as self-employed persons'. Similarly, in Case C-221/89, *Factortame II*, the Court held that an establishment 'involves the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period.'³ Finally, in the Case C-196/04, *Cadbury Schweppes*, the Court established that the question whether there is an actual establishment should be 'based on objective factors which are ascertainable by third parties with

² OECD, *Report on the Misuse of Corporate Vehicles for Illicit Purposes*, 2001, p. 23 et seq.

³ See para. 20. This has been repeated several times including in Case C-246/89 *Commission v United Kingdom*, para. 21; and Case C-196/04 *Cadbury Schweppes*, para. 54.

regard, in particular, to the extent to which the [company's] physically exists in terms of premises, staff and equipment.'⁴

It thus seems that an establishment requires a fixed location with some sort of staff, it should be set up for an indefinite period and some sort of commercial activities should be associated with it. It is possible to elaborate a little on these conditions. The requirement for a fixed location means that the establishment should have a fixed address. It is not enough for a company to have its own premises; it should also have some level of staff and equipment.⁵ There should be some commercial activity associated with the establishment. The test is whether there is 'any genuine economic activity'.⁶ It will not be enough to register a business activity if there is no intention of actually carrying on the activity.⁷ The Court has not defined what level of activity should be associated with an establishment, but judging by the interpretation of cases on the free movement of workers, it seems likely that it will include any activity other than what can be termed 'purely marginal'.⁸ There cannot be a requirement for a certain level of profit, but there must be sufficient activity to qualify as being a commercial activity.⁹

If a company is incorporated without any activities, the incorporation will not be protected by the freedom of establishment and consequently, Member States are free to deny the incorporation of the company.¹⁰ Also, the Court has accepted that companies are creatures of national law, and therefore Member States may impose some requirements of a link to the state of incorporation to be fulfilled when the company is formed and later.¹¹ For instance, a Member State may require that the company has its management in the state of incorporation. Member States applying the real seat theory in international private law would require that the real seat of the company is in that Member State. However, not every Member State requires that companies should have a substantial link to the state of incorporation, and therefore setting up letterbox companies will be possible in many Member States.¹²

If an existing company which is doing business in a Member State wants to incorporate in a different Member State, but without the intention of having any establishment in the new Member State, this transaction will not be protected by the freedom of establishment. This was made clear in the recent case

⁴ See Case C-196/04, *Cadbury Schweppes and Cadbury Schweppes Overseas*, para. 67.

⁵ Case C-196/04, *Cadbury Schweppes*, para. 67.

⁶ See Case C-196/04, *Cadbury Schweppes*, para. 68.

⁷ See also Case C-211/89, *Factortame II*, para. 21.

⁸ Case 53/81 *Levin*, para. 17.

⁹ Thus, in a Danish judgement it was established that the efforts of an architect to set up a branch of his German firm in Denmark were not enough for an establishment since they were purely marginal in character; see the judgement of the Eastern High Court reported in *UfR* 1999, p. 516.

¹⁰ Similarly Christopher Teichmann, 'Gesellschaftsrecht im System der Europäischen Niederlassungsfreiheit', *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 2011 pp.639-689 and Wolfgang Schön, 'Der System der gesellschaftsrechtlichen Niederlassungsfreiheit nach VALE', *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 2013 pp. 333-365. If the natural or legal person intending to incorporate the company already has activities, it will depend on the circumstances whether the incorporation of a letterbox company will be covered by the right of establishment. If Danish persons conducting business in Denmark want to incorporate a letterbox company in the UK, this will not be covered by Article 49. If a Danish person is conducting business in Denmark and Germany and wants to incorporate in the UK, he or she may be able to invoke Article 49 since he or she is already performing an establishment in Germany and the incorporation may be seen as part of this activity.

¹¹ See Case 81/87, *Daily Mail*, paras 19-23.

¹² For a recent comparative overview of the choice of law rules for companies, see Paschalis Paschalidis, *Freedom of Establishment and Private International Law for Corporations*, 2012 pp. 5-14.

C-372/10, *VALE Építési*. The case involved an Italian company that wanted to convert into a Hungarian company. Hungarian law did not allow for such a conversion, and the question was whether this poses a restriction on the freedom of establishment. Firstly, the Court noted that Article 49 presupposes an actual establishment and the pursuit of genuine economic activity in the host Member State. However, in this case the Court found nothing to suggest that VALE Építési will not actually seek to establish itself in Hungary.¹³ This case implies that there would not be an establishment if the company maintained its activities in Italy but would not move any of these to Hungary.¹⁴ Thus, the establishment of a letterbox company by converting an existing company into a company having its seat in another Member State without having any activity in the latter Member State does not seem to be protected by the freedom of establishment.¹⁵ Consequently, it must be possible for the Member State where the company intends to register to take steps to prevent the conversion in this case, but it is doubtful whether the Member State of origin can do that.¹⁶

2.2. Letterbox companies exercising free movement

Companies benefit from the internal market as they are guaranteed the freedom of movement according to both the right of establishment and the freedom to provide services, cf. Articles 54 and 62 TFEU. Article 54 provides a very broad definition of the companies that can claim the two rights, and this definition does not seem to exclude letterbox companies. According to Article 54(1), companies must have “their registered office, central administration or principal place of business within the Union”. The listed criteria seem to be alternative, and therefore it is enough that the company has its registered office in the EU and there is no requirement that it should also have activities in the same Member State (or in any Member State).

However, the Member States were very early aware that letterbox companies which were easy to establish in some Member States could make it very easy to get access to enjoy the right of freedom of movement. It was particularly feared that companies from third countries would be able to use the internal market by establishing a letterbox company in the Netherlands. Therefore, a requirement was imposed that companies that only have their seat situated within 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

¹³ Case C-378/10 *VALE Építési kft.*, paras. 34-35.

¹⁴ Christoph Teichmann, ‘Der Grenzüberschreitende Formwechsel ist spruchreif: das Urteil der EuGH in der RS. Vale’, *Der Betrieb* 2012 pp. 2085-2092, at 2088 points out that the Member State’s duty not to discriminate may prevent a Member State from enforcing a requirement that the company under conversion should have a real link to the host Member State if such a requirement is not imposed on domestic conversions. However, this argument seems to overlook the fact that if the consequences are that the conversion will not be protected by the freedom of establishment in the case where an actual establishment has not taken place, then the ban on discrimination will not apply. Therefore, it seems possible to treat domestic and cross-border conversions differently on this point.

¹⁵ Again a reservation may be made in the case that the Italian company performs cross-border activities in another Member State than Hungary, see note 10 above.

¹⁶ See the discussion in Daniel Szabó & Karsten Engsig Sørensen, ‘Cross-border conversion of companies in the EU: The impact of the VALE judgment’, *International and Comparative Corporate Law Journal* 2013 pp. 43-56 and Wolfgang Schön, ‘Der System der gesellschaftsrechtlichen Niederlassungsfreiheit nach VALE’, *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 2013 pp. 333-365.

Member State”.¹⁷ The implication is that letterbox companies formed without any activities in the Union cannot rely on the right of establishment and nor the freedom to provide services. The Court has subsequently accepted that companies without any activities in the EU cannot rely on the free movement rights.¹⁸

Even though there should be some activities within the EU, this does not mean that the activity should be in the Member State of incorporation.¹⁹ In Case C-212/97, *Centros* the Court held that there was an establishment even in the situation where a company was set up in one Member State for the sole purpose of establishing a branch in a second Member State, and even if the entire commercial activity of the company was in the Member State where the branch was situated.²⁰ Thus, a Member State cannot make the registration of a branch conditional on the carrying on of certain activities in the Member State where the company is incorporated.²¹ Nor can it be required that a company’s head office or real seat is located in the Member State where it is incorporated.²² Accordingly, as long as a company satisfies the connecting factors required by national law in the state of incorporation, it is entitled to exercise free movement.²³ As mentioned above, many Member States do not require a company to have commercial activities or their ‘real seat’ in the State of incorporation, and therefore this judgement has the important consequence of allowing letterbox companies to operate within the EU. Also the judgement is opening up for ‘forum shopping’ for incorporation.²⁴

2.3. Abuse of free movement rights

In a long line of cases the Court has established that the free movement rights cannot be abused.²⁵ Thus, where the purpose of exercising free movement is contrary to the purpose pursued by the free movement

¹⁷ See General Programme for the abolition for restrictions on freedom of establishment OJ 1962 36/62 and General Programme for the abolition of restrictions on freedom to provide services, Title 1, English special edition: Series II Volume IX.

¹⁸ See Case C-208/00, *Überseering*, para. 75.

¹⁹ In addition, the activity does not have to be within that company, but may be in a subsidiary controlled by the company. Thus, a holding company which has no other activity than holding shares in other companies was able to rely on the freedom of establishment. See in this regard Case C-157/05, *Holböck*.

²⁰ See Case C-212/97, *Centros*, para. 17.

²¹ See also Case C-167/01, *Inspire Art*, para. 97.

²² See also Case C-208/00, *Überseering*, para. 75.

²³ The Member State of incorporation may apply the real seat theory by requiring that the company keeps its real seat in that Member State or it may require a different kind of link to the Member State of incorporation. Other Member States, on the other hand, cannot impose such requirement on companies incorporated in other Member States, see Case C-208/00, *Überseering*.

²⁴ For a discussion about how regulatory competition for incorporation may have emerged as a consequence of this line of cases, see William W. Bratton, Joseph A. MacCahery & Erik P. M. Vermeulen, ‘How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis’, 57 *American Journal of Comparative Law*, 2009, pp. 347-386; and Wulf-Georg Ringe, ‘Sparkling Regulatory Competition in European Company Law: The impact of the Centros Line of Case Law and its Concept of “Abuse of law”’, in Rita de la Feria & Stefan Vogenaur (eds.): *Prohibition of Abuse of Law. A New General Principle of EU Law?*, Hart Publishing, 2011, pp. 107-126.

²⁵ The literature on the abuse of rights in EU law includes: Rita de la Feria, Prohibition of abuse of (Community) law: The Creation of a new general principle of EC Law through tax’, *Common Market Law Review*, 2008, pp. 395-441; Karsten Engsig Sørensen, ‘Abuse of rights in Community law: A principle of substance or merely rhetoric’, *Common Market Law Review*, 2006, pp. 423-459; and Anders Kjellgren, ‘On the border of abuse: The jurisprudence of the European Court of Justice on circumvention, fraud and other misuses of Community law’, *European Business Law Review*, 2000, pp. 179-194.

rights, the Court accepts that Member States may take steps to prevent that use. This raises the question whether the use of a letterbox company may constitute an abuse of EU law.

It was established in the *Centros* judgement that even if a person chooses to set up his/her company in the Member State with the least restrictive company law rules with the sole purpose of setting up a branch in another Member State, there will be no abuse of the right of establishment.²⁶ In the same case the Court allowed that there could be situations where abuse can be established on a case-by-case basis.²⁷ However, subsequent cases show that there will be very few cases in which a Member State will be able to argue that incorporation in another Member State to avoid company law regulation in a specific Member State is likely to be an abuse of the right of establishment.²⁸

However, the *Centros* case concerned a situation where setting up a letterbox company was used to “avoid” company law rules in a different Member State and therefore may not apply to the use of letterbox companies to avoid other types of rules. In fact, in the *Centros* case, the Court did make a distinction between rules governing the formation of companies and rules concerning the carrying on of certain trades, professions or businesses.²⁹ It may thus be easier to argue abuse in cases where the intention is to avoid the “rules concerning carrying on of certain trades, professions or businesses”.

The Court has been more willing to accept that artificial arrangements to avoid tax may abuse the free movement rights.³⁰ One of these cases concerned a letterbox company. In Case C-196/04 *Cadbury Schweppes*, the Court held that there may be an abuse where a person or company is pursuing different objectives than those that lie behind the right of establishment. That would be the case where a company is set up without there being a real establishment.³¹ This case indicates that if a letterbox company is set up without any activities, it will not be protected by the freedom of establishment. This is hardly surprising since it already follows from sections 2.1 and 2.2 above that a company without real activities anywhere in the Union cannot rely on the free movement rights.³²

There are older cases which indicate that the freedom to provide services may not be used to avoid the application of the law in the Member States where the services are predominately provided. Going back to the *Van Binsbergen* case, the ECJ held that Member States can take measures to prevent a person exercising the freedom to provide services in order to prevent the application of the professional rules of conduct which would have been applicable to him if he had been established in the Member State where he provides services. The ECJ pointed out that this could be the case where the service provider’s activities

²⁶ See Case C-212/97, *Centros*, para. 27.

²⁷ See Case C-212/97, *Centros*, para. 25.

²⁸ Thus, the Court did not find abuse in Case C-167/01, *Inspire Art*, para. 140; or in the earlier Case 79/85, *Segers*, para. 16.

²⁹ See Case C-212/97, *Centros*, para. 26.

³⁰ For an analysis of these cases, see Dennis Weber, *Tax Avoidance and the EC Treaty Freedoms*, Kluwer Law, 2005; and several of the contributions to Rita de la Feria & Stefan Vogenaur (eds.), *Prohibition of Abuse of Law. A New General Principle of EU Law?*, Hart Publishing, 2011.

³¹ Further elaborated in Case C-196/04 *Cadbury Schweppes*, paras. 64-71

³² See also Christopher Teichmann, ‘Gesellschaftsrecht im System der Europäischen Niederlassungsfreiheit’, *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 2011 pp.639-689.

are wholly or principally directed towards the territory of the Member State where the person had previously been established.³³

This case seems to indicate that if a company formerly established in one Member State becomes established in another Member State, thereby avoiding the national law of the first Member State, there may be a circumvention of national law which constitutes abuse. However, subsequent case law has indicated that there is no requirement for a company to have been formerly established in another Member State, and thus to have 'escaped' national law by moving.³⁴ There could also be circumvention if a company was originally established in Member State 'A' if it would have been more natural for it to have been established in Member State 'B' because that is where all its customers are.

This could imply that Member State A may take steps to prevent that letterbox companies, although incorporated abroad, may not avoid the national legislation (apart from company law) if they have all or most of their activities in Member State A.³⁵ That would be the case even if the company is in fact established in another Member State. However, the cases mentioned are all relatively old and the Court has not used this relatively broad approach to what constitutes abuse for several years. Especially, it has not confirmed the cases following the *Centros* judgement. Therefore, it is not certain that the Court will still allow the abuse-doctrine to be applied against letterbox companies solely based on the premises that these are trying to avoid rules in the Member State where they provide their services.³⁶

2.3. Summing up

The freedom of establishment does not protect the person or company that wants to set up a letterbox company with no activities in that Member State. Therefore, Member States can prevent the setting up of letterbox companies for instance by requiring a genuine establishment in the Member State of incorporation. However, this is seldom done and consequently, it is relatively easy to set up a letterbox company in the EU.

A letterbox company may exercise the free movement rights if it has business activities in one of the Member States. It is not a requirement that the activity is in the Member State of incorporation and thus this kind of letterbox company may rely on the right of establishment and the freedom to provide services.

The *Centros* case made it clear that it is not abuse of EU law to incorporate a letterbox company in the Member State with the most attractive company laws. The Court may be a little more positive in allowing Member States to encounter abuse in the situation that a letterbox company is used to avoid other types of legislation, but the existing case law on this may be outdated.

³³ See Case 33/74, *Van Binsbergen*, para. 13.

³⁴ See Case C-23/93, *TV10* and Case C-148/91, *Veronica*.

³⁵ The most logical way to encounter abuse in these cases is to treat the service provider as being established in the Member State where it provides services. Earlier rulings by the CJ applied the freedom of establishment in cases like this, but later the CJ applied the provision on services. But by using the abuse-argument the CJ accepted that it should be possible to impose national requirements on such service providers to the same extent these applied to domestic service providers, see the discussion by Wulf-Henning Roth in Manfred A. Daus (ed.): *Handbuch des EU-Wirtschaftsrecht*, looseleaf para. 181.

³⁶ Already in Case C-56/96, *VT4*, the Court seems reluctant to apply the very broad abuse doctrine. See also the doubt expressed by Catherine Barnard, *The Substantive Law of the EU*, Fourth Edition, 2013 p. 402 and Alan Dashwood et al, *Wyatt and Dashwood's European Union Law*, Sixth Edition, 2011 p. 568.

Therefore, in conclusion the free movement rights generally protect the use of letterbox companies and have done more to promote their use than to limit it. This is mainly due to the seminal judgement in *Centros*. Given this development, it would be natural to expect that secondary legislation had dealt with the problem which letterbox companies cause. This will be examined next.

3. Letterbox companies and the harmonisation of company law

Already in the *Centros* case the Court made it clear that if the Member States were not happy about the fact that persons wishing to set up a company could choose the company law less restrictive, it was open for them to remove the differences between national company law by harmonising according to what is now Article 50(2)(g) of TFEU.³⁷ However, little was done in the way of harmonisation. Instead the *Centros* judgement resulted in a large number of companies being formed, especially in the UK, used for activities in other Member States. The increased use of letterbox companies continued until 2007-2008 where the trend seems to have been reversed.³⁸ The main reason for this reversal seems not to be any harmonisation undertaken by the EU, but reforms of national company law whereby the incorporation cost and especially the minimum capital requirement were diminished.³⁹

The fact that little has been done in the harmonisation of companies to encounter letterbox companies is surprising because company law seems to be the only regulation which may be used to combat the use of letterbox companies on a broader scale. From time to time the European Parliament warned against letterbox companies when discussing company law harmonisation, but this has not resulted in any significant measures against letterbox companies.⁴⁰ The fact that abuse of the corporate form has not been addressed in the harmonisation may even make it difficult for the Member States to implement their own measures.⁴¹

³⁷ Para. 28 of the judgment.

³⁸ See Marco Becht, Colin Mayer & Hannes F. Wagner, 'Where do firms incorporate? Deregulation and the cost of entry', 14 *Journal of Corporate Finance* 2008, pp. 241-256; Wolf-Georg Ringe, 'Corporate Mobility in the European Union – a Flash in the Pan? An empirical study of the success of lawmaking and regulatory competition', *European Company and Financial Law Review* 2013, pp. 230-267; and Karsten Engsig Sørensen, 'Branches of Companies in the EU: Balancing the Eleventh Company Law Directive, National Company Law and the Right of Establishment', *European Company and Financial Law Review* 2014 pp. 53-96.

³⁹ See Reiner Braun, Horst Eidenmüller, Andreas Engert and Lars Hornuf, 'Does Charter Competition Foster Entrepreneurship? A Difference-in-Difference Approach to European Company Law Reforms', *Journal of Common Market Studies* 2012 pp. 1-17.

⁴⁰ See for instance the Parliament resolution with recommendation on a 14th company law directive on the cross-border transfer of company seats, (2011/2046(INI)). The Parliament supports a directive on cross-border transfer of seats but stresses that "the misuse of post-box offices and shell companies with a view to circumventing legal, social and fiscal conditions should be prevented." It remains to be seen whether the Commission will address this problem in the directive as no proposal has so far been proposed. In the previous draft for a directive on the transfer of seat there was nothing to prevent such misuse. The draft directive did allow Member States to enforce a requirement that the central administration of the company should be in the state where it is to be registered, but there was no requirement that Member States must require this, see Karsten Engsig Sørensen and Mette Neville, 'Corporate migration in the European Union', *Columbia Journal of European Law* 2000 pp. 181-208.

⁴¹ Thus, in Case C-106/89, *Marleasing*, it was made clear that the First Company Law Directive does not allow Member States to provide for the nullity of companies based on the fact that the formation is a pro forma transaction intending

However, in relation to SE-companies (*Societas Europaea*) steps have been taken to prevent the use of letterbox companies. First, Article 2(5) of the SE-Statute allows the Member States to bar some types of letterbox companies from participating in the formation of a SE-company. If a company does not have its head office in the EU, then Member States may require that the company “has a real and continuous link with a Member State's economy.”⁴² This requirement is clearly inspired by the General Programme for the abolition of restrictions on freedom of establishment and on freedom to provide services, see section 2.2, and it aims to make sure that letterbox companies without any activities in the EU cannot participate in the formation of a SE-company.

Article 7 of the SE-Statute provides that the head office of an SE-company should be located in the Member State where the company is registered. This requirement aims to ensure that SE-companies may not be letterbox companies with no real link to the place where they are incorporated (registered). It may, however, prove difficult to enforce this requirement. First, the concept of “head office” is not defined in the SE-Statute, and evidently it may prove difficult to decide what it takes to fulfil this requirement.⁴³ Second, it is not made clear how it should be checked whether this requirement is fulfilled. It should be checked at the time of formation but how should it be controlled afterwards?⁴⁴ The consequences of not fulfilling this requirement are partly regulated in Article 64 of the SE-Statute. If a SE-company moves its head office to another Member State, the Member State where the SE-company is registered should ensure that this is remedied by either moving back the head office or by transferring the registered office to the Member State where the head office is now positioned. If the SE-company does neither of these, Article 64(2) requires the Member State in which the SE's registered office is situated to put in place the measures necessary to ensure that the SE-company is liquidated. Even though some details are left for the Member States, Article 64 overall seems to regulate the main features of how such a requirement can be enforced.

The solution to prevent SE-companies to be used as letterbox companies does not seem to be copied to any of the other EU corporate forms. Even in the recently proposed Directive for a single-member limited liability company (SUP) there is no similar requirement or any other measures to prevent SUPs to be used as letterbox companies.⁴⁵

It has been claimed that the solution in Article 7 of the SE-Statute may infringe the freedom of establishment since it requires companies to have their head office in the state of incorporation which the Court did not seem to accept in the *Centros* case.⁴⁶ However, the Court has accepted that the Member State of incorporation is allowed to impose requirements to the link which a company must have (and

to deceive the creditors of the incorporator, since this is not one of the grounds for nullity listed in what is now Article 12 of Directive 2009/101/EC.

⁴² According to para. 23 of the preamble of the SE-Statute, Regulation 2157/2001; “Such a link exists in particular if a company has an establishment in that Member State and conducts operations there from.” This solution has also been adopted for the formation of a European Cooperative, see SCE-Statute, Regulation 1435/2003, Article 2(2).

⁴³ See also Peer Schaumburg-Müller & Erik Werlauff, *SE-selskabet – det europæiske aktieselskab*, 2011 pp. 143-144.

⁴⁴ Article 64 seems to assume that information about the fact that the head office has been moved may come from both individuals and Member States. According to Article 64(4), the Member State, whereto the head office has been moved, has a duty to inform the Member State, in which the SE-company is registered, that the head office has been moved.

⁴⁵ See COM(2014) 212 final.

⁴⁶ See Eddy Wymeersch, ‘The transfer of the company's seat in European Company Law’, *Common Market Law Review* 2003 p. 661-695 and further references in Stefan Grundmann, *European Company Law*, 2012, 2nd ed., p. 830.

maintain) to that state, and for the same reason it must be allowed for the EU legislator to make similar requirements for EU corporate forms.⁴⁷ Consequently, this method of preventing companies to be used as letterbox companies should not contravene with EU-law and can even be transferred to national company law. However, there is no evidence that Member States are moving towards introducing requirements similar to Article 7 in the SE-Statute for national corporate forms, and there are no plans to harmonise company law on this matter. Member States, applying the real seat theory, may still require companies incorporated in that Member State to have their head office in that state. However, the application of the real seat theory is in decline since some of the Member States that used to adhere to that theory are now applying the variant of the incorporation theory.

To sum up, the harmonisation of company law in the EU has done something to prevent SE-companies to be used as letterbox companies but has done nothing to prevent national companies to be used as such. Consequently, it is up to the Member States what link they require companies to have to the state of incorporation and afterwards. With the tendency to abandon the real seat theory, it seems that the Member States are moving in the direction of lessening the requirement of a link to the state of incorporation and consequently, company law does not add much to solving the problem of letterbox companies.

4. Sector specific regulation of letterbox companies

Since the EU had done very little to prevent the use of letterbox companies, it was left for the Member States to cope with these. It has, however, proven to be difficult for the Member States to do this because it often involved cross-border situations where investigations and enforcement are difficult, and because it is not crystal clear how far the free movement rights protect letterbox companies, see section 2 above. In recent years the EU has tried to help the Member States by introducing (or proposing) legislation which aims to make it easier for Member States to prevent letterbox companies from undermining the internal market in sectors where problems have been identified. To understand this sector-specific approach, a brief account of the different sectors involved and of the legislation introduced is required.⁴⁸

4.1. Posting of workers

Regarding posted workers, there have been increasing problems with employers using letterbox companies. The problem seems to be that the companies claim to be established in other Member States and are thus apparently complying with the legislation there. Consequently, they claim that they cannot in full be subject to the legislation in the Member States where they post workers in order to supply services. Given that the service provider has no real activities in the Member State the company claims to be established in, there does not seem to be any reason for not applying the legislation in full in the Member State where the workers are posted. Also the fact that the service provider is an empty company without

⁴⁷ The Court accepted the requirement in the SE-Statute in Case C-210/06, *CARTEIO*.

⁴⁸ The following only includes those areas which have implemented a harmonization that aims to counter letterbox companies. However, letterbox companies have also been a problem in other areas. Thus, there are examples that the Court of Justice has had to deal with these, cf. regarding VAT case C-73/06, *Planzer Luxembourg* as well as in relation to insolvency regulation, case C-341/04, *Eurofood*.

funds may also make it difficult for the posted workers to get the salary they are entitled to. The problem with letterbox companies seems to have spread to several Member States. A report on the revitalization of the internal market prepared by the previous European Commissioner Mario Monti stated the importance of fighting letterbox companies: "In this context, it is also of key importance that the fight against "letter box companies" is intensified and that posted workers' access to legal remedies against abuses of their rights suffered in the host country is strengthened."⁴⁹

In 2012, the Commission proposed a directive to improve the enforcement of the Posted Workers Directive (Directive 96/71/EC).⁵⁰ The proposal did not intend to change the Posted Workers Directive but to introduce rules and procedures which to a greater extent ensure compliance with the directive, including counter circumvention of letterbox companies. After several years of negotiations, an agreement on the directive was reached in the spring 2014.⁵¹

The directive includes several interesting initiatives to counter letterbox companies. First of all the directive specifies the definitions of when there is a genuine establishment and a genuine posting. In relation to the fight against letterbox companies, the former is particularly interesting as it is intended to ensure that the company posting employees is not just a letterbox company. The introduction of article 4 of the directive determines that the assessment of whether it is a genuine establishment is based on a comprehensive assessment of a number of factual elements listed in the directive. Cf. Article 4(2), these elements are:

- "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"*

The elements stated are not exhaustive. The elements have in common that they seek to identify where the activities, that are central to most service companies, actually are exercised. If all or most of these activities are performed elsewhere than in the Member State of establishment, the company in the Member State of establishment will solely exercise what is characterised as "*purely internal management*

⁴⁹ Mario Monti: *A new strategy for the Internal Market*, May 2010, p. 70. The report is available on http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

⁵⁰ COM(2012) 131.

⁵¹ See Directive 2014/67/EC concerning the posting of workers in the framework of the provision of services and amending Regulation (EU) No 1024/2012 on administrative cooperation through the Internal Market Information System ('the IMI Regulation'), OJ 2014 L 159/11.

and/or administrative activities", and it will not be a genuine establishment. Consequently, it is not necessary to accept that it is a foreign company exercising the freedom to provide services.

Moreover, the Member States are urged to try to identify who is behind these letterbox companies. Para 42 of the preamble states that in cases where a service provider is not really established in the Member State in which the company is formed, Member States should not conclude the procedure but should investigate the matter to further establish the identity of the natural person or legal person who is responsible for the posting. The identification of those behind the letterbox companies is important as the directive also is committing the Member States to introduce effective sanctions in relation to those who do not comply with the rules of the Posted Workers Directive. In addition, the new directive suggests a strengthened enforcement of the sanctions across borders.

It will be most obvious that the Member State, where the posting takes place, starts the investigation. However, clearly this Member State may have difficulties in conducting the investigation on its own as the investigation requires an identification of the activities taking place in the Member State in which the company is formed. Thus, the directive requires that the Member States collaborate on these investigations. Pursuant to Article 7(5) of the directive, the Member State can thus request the Member State of establishment about "*... to provide information as to the legality of the service provider's establishment, the service provider's good conduct, and the absence of any infringement of the applicable rules.*"

However, it can be difficult to assess whether there is a genuine establishment, and if the Member States cannot agree on this assessment, this may entail that the company be put in a hard place between the two Member States as it may be regarded as established in both or none of these. Even though the directive suggests an individual assessment of the individual cases, the directive also aims, through the listed elements, to contribute to ensure that the authorities in the various countries will reach the same assessment in the individual cases.⁵²

Finally, the directive includes rules on what the directive calls subcontracting liability, but which is sometimes referred to as chain liability. This means that the Member States may impose the main contractor to be liable for a sub-contractor's lack of payment of any outstanding remuneration or contributions to common funds due to the posted workers, cf. further Article 12. In the construction industry such a vicarious liability is a requirement although the Member States are allowed to introduce alternative measures. This liability for subcontractors is a measure which counters fraud and evasion, and when a service provider turns out to be an empty letterbox company, the liability may ensure that the posted workers are given their back pay. The directive, however, only suggests liability for the first link in the subcontracting chain, and doubt has been expressed as to whether the directive will have the desired effect. Thus, there is a risk that more letterbox companies will just be formed to make a longer chain of subcontractors and thus make the responsibility illusory.⁵³ The Member States, however, have the opportunity to introduce more far-reaching rules on responsibility for sub-contractors as long as this takes place on "*...a non-discriminatory and proportionate basis*", cf. Article 12(4)

⁵² Cf. point 6 in the preamble of the directive.

⁵³ This fear has thus been formulated in the article "Faglige protester mod ny EU-lov" dated 16/1-2014 available on www.3for.dk.

4.2. The road transport sector

International road transport operators conduct transport in many countries and thus it is natural to consider where it is most appropriate to register their lorries, hire their workers etc. This may also tempt the road transport operators to use letterbox companies.

There seems to be some use of letterbox companies in the transport sector to evade taxes or other restrictive rules. Thus, in 2009 provisions to prevent the use of letterbox companies were introduced. These are found in regulation 1071/2009 establishing common rules concerning the conditions to be complied with to pursue the occupation of road transport operator. Pursuant to Article 3 (1)(a), it is, i.a., a condition for the occupation of road transport operators that they "*have an effective and stable establishment in a Member State*". The requirement about an effective and stable establishment is specified in Article 5:

"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 documents 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."

This provision thus seeks to formulate minimum requirements as to what constitutes an effective and stable establishment based on the assignments, documents and assets which a road transport operator must be expected to have. The provision seems quite precise, although it requires an overall assessment. The regulation also requires that the Member States control that undertakings, which has been authorised to engage in the occupation of road transport operator, continue to meet the requirements set out in Article 3, including the requirement of an effective and stable establishment, cf. Article 12(1). Until the end of 2014, the Member States must, at least every five years, control that the undertakings continue to meet the requirement.

Despite of these rules, there are indications of unsolved problems with letterbox companies. In Denmark, a TV programme gave rise to a discussion about the practice which a number of Danish road transport operators had developed by having letterbox companies in Germany. Subsequently, the issue was raised in the European Parliament where Ole Christensen and Jutta Steinruck on 14 January 2014 asked the

Commission whether the road transport operator H. P. Therkelsen commits an offence against the rules of Regulation 1071/2009, when it *first* registers lorries on German number plates through the company's German subsidiary with address in Flensburg, just south of the Danish-German border, *second* administers both its Danish company and its German subsidiary from the Danish company's address in Padborg just north of the Danish-German border, *third* conducts all its actual business activities from the Danish address in Padborg, and finally files all core documents on the Danish company address in Padborg.⁵⁴ In its response dated 28 February 2014, the Commission repeated the regulation's requirement of an effective and stable establishment and notified that it will request the German authorities to carry out a control of the company mentioned in the question.

Apparently, it is a more widespread problem. In the Commission's report on the State of the Union Road Transport Market published in April 2014 it is stated:⁵⁵

“Punctual reports also show that 'letterbox' companies (that is to say, companies 'established' in a Member State for tax purposes, where they do not carry out their administrative functions or commercial activities, in violation of Article 5 of Regulation (EC) No 1071/2009) still exist in certain Member States. This practice is not in line with the intention of the legislator. Such practices are occasionally documented,⁵⁶ but remain difficult to quantify due to their illegal nature.

Such 'letterbox' companies continue to exist due to the differences in resources and priority levels given to enforcement in the Member States concerned. This may create difficulties for other Member States reporting such companies to their Member States of registration, who may not be able to rely on a strong level of support from their counterparts. In addition, the provisions regulating enforcement of the 'stable establishment' requirement are weak. There seems therefore to be a case for increased cross-border cooperation in this area, and for a more stringent enforcement of the relevant provisions.”

Although quite precise requirements have been formulated for what constitutes a genuine establishment, there seems to be problems with the enforcement of these requirements. According to the Commission, the problem could be solved by clarifying how to execute the control in the regulation. So far, however, no proposal on changes of the regulation has been presented.

4.3. Certain types of crime

In a report from 2001, OECD pointed out that companies can be used for different types of crime. This includes, i.a., money laundering, bribery and corruption, hiding assets from creditors, different types of illegal fiscal practices, illegal self-dealing and evasion of the rules which prohibits insider dealing.⁵⁷ This type of crime is often performed by letterbox companies as the companies have no real business activity in the country in which they are established. The report reviews the various types of companies which are

⁵⁴ Cf. inquiry of 14 January 2014, E-000305-14.

⁵⁵ Cf. report COM(2014) 222 p. 15.

⁵⁶ The inspection activity within posting of workers in the road transport: a guide for control authorities. Final report of the TRANSPO project, March 2012 www.tagliacarne.it/download/229.html

⁵⁷ Cf. OECD: *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes*, 2001, s. 33-37.

engaged in such criminal activities, and the report concludes that within the EU mainly private limited companies are used, whereas internationally also other types of companies are used, including international business corporations (IBC), exempt companies, trusts and funds. It is a common feature that the preferred types of companies ensure the anonymity of the owners. Anonymity can be ensured by 1) issuing of bearer shares, 2) allowing 'nominee shareholders', i.e. permitting others - for example dealers - to be registered as owner of the shares, 3) allowing a 'nominee director', who is a person who lets him/herself register as director, but leaves the tasks associated with being a director to another, or 4) allowing a company to be registered as director.

Already in the report from 2001, OECD suggested to meet this type of misuse of corporate vehicles by providing and sharing information about who is 'beneficial owner'. Subsequently, the Financial Action Task Force (FATF) under OECD formulated recommendations for beneficial ownership. The latest recommendations from 2012 recommend that all states should ensure that the authorities have access to information on who are beneficial owners in companies in the country where the company is registered.⁵⁸ Then, it is recommended that countries allowing the use of bearer shares, bearer share warrants, nominee shareholders or nominee directors must take effective measures to ensure that these are not being abused for criminal activities, cf. recommendation 24. FATF defines 'beneficial owner' as the natural person exercising control of the legal person. It is stated that normally control is exercised by the person who owns more than 25 % of the company, but control may also be exercised through other means.⁵⁹

Most recently the government leaders at the G20 meeting in Russia in September 2013 recommended more exchange of information in order to counter tax evasion and thereby they referred to FATF's recommendations on beneficial ownership.⁶⁰ Previously at a meeting in June 2013 in Northern Ireland, the G8 agreed on the action plan: "Principles to prevent the misuse of companies and legal arrangements". The plan also includes an invitation to introduce rules which ensure insight into who are the beneficial owners of the company.⁶¹

In the Money Laundering Directive, EU has ordered the financial institutions, which are covered by the directive, to ensure that they have the information needed about the beneficial owners of the companies which are going to be their customers.⁶² The beneficial owner is defined as "*natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage of the shares or voting rights in that legal entity*". It is stated that 25 % plus one share normally

⁵⁸ The recommendations also cover trusts. Trusts are also covered by the Money Laundering Directive, see the text below. These rules are important as trust - after companies is the framework most often used for crime, cf. Emile van Does the Willebois et al: *The Puppet Master: how the corrupt use legal structures to hide stolen assets and what to do about it*, 2011 s. 33-34. The report is available on <https://star.worldbank.org/star/publication/puppet-masters>. The rules intended to ensure greater transparency for trusts are not dealt with here.

⁵⁹ Cf. Interpretative note to Recommendation 10.

⁶⁰ Cf. point 51. The declarations are available on <http://www.cfr.org/international-organizations-and-alliances/g20-leaders-declaration-september-2013/p31355>

⁶¹ Cf. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207532/G8-Action-Plan-principles-to-prevent-the-misuse-of-companies-and-legal-arrangements.pdf

⁶² Cf. the Money Laundering Directive 2005/60/EF art. 8(1)(b).

is sufficient, but furthermore it includes the natural person(s) who otherwise exercises control over the management of a legal entity.⁶³

In the light of the recommendations issued by the FATF and the conclusions at the G8 and G20 meetings, the Commission suggested in 2013 the Money Laundering Directive to be changed, so that companies are obliged to be in possession of information on who are their beneficial owners. Thus, it is possible for the authorities to get access to this information by contacting the company.⁶⁴ In March 2014, the Commission's proposal was discussed in the Parliament.⁶⁵ Among others, the Parliament proposes that EU companies become obliged to submit information about their beneficial owners (and about the members of the management) to a central register which is managed by each Member State. The information must be available for the authorities in all Member States and it must be publicly available. Then the Parliament proposes that these records must be linked to each other in accordance with the model, which is used to combine the registers of companies in directive 2012/17/EC. Finally, the Parliament proposes to introduce rules obliging the Member States to introduce effective sanctions in the case the duty of disclosure is not met, and likewise the Member States must introduce rules which prevent circumvention through the use of bearer shares.

Undoubtedly such a register will make it easier to prevent many types of crime. However, it must be assumed to be a challenge to ensure that the register contains updated information about the companies' beneficial owners.

It is still uncertain how the Council and the Parliament will reach an agreement on the directive. The Council has reached an agreement on its position in June.⁶⁶ The proposal which was proposed by the Presidency as a compromise on 13 June 2014 seems not to go as far as proposed by the Parliament. It seems to require companies to submit information on beneficial ownership to a central register which can be accessed by the authorities and furthermore Member States may allow "obliged entities", for instance a bank, access.⁶⁷ But the proposal does not provide for public access. If this compromise will be the final directive, it may be that some Member States will opt for a solution with wider public access as both the UK and France, based on the G8 meeting, are positive towards introducing a publicly available register with information about beneficial owners.⁶⁸

The directive - if it is passed - will be limited to apply to companies established in the Member States in the EU. Clearly an effective action against these types of companies requires an effort to make countries outside the EU introduce similar rules. Here it is interesting that the other G8 countries also are prepared to ensure greater access to information on who are beneficial owners. But the greatest challenge is to get tax havens included in these efforts. The Parliament's amendment to the Money Laundering Directive

⁶³ See Article 3(6) of the Directive.

⁶⁴ Cf. COM(2013) 45, article 29. In addition Article 30 includes a rule which shall apply to trusts.

⁶⁵ Cf. The Parliament's resolution of 11 March 2014 (P7_TA(2014)0191).

⁶⁶ See press release 347 entitled "Council agrees a negotiating mandate on money laundering" dated 18 June 2014.

⁶⁷ See the compromise proposal dated 13 June 2014, 2013/0025 (COD), article 29.

⁶⁸ See the report *Open Government Partnership UK National Action Plan 2013-2015* available on <https://www.gov.uk/government/consultations/open-government-partnership-uk-national-action-plan-2013> and Christian Aid & Global Witness, *Company ownership: Which places are the most and least transparent*, 2013, available on

http://www.globalwitness.org/sites/default/files/library/GW_CA_Company%20Ownership%20Paper_download.pdf

proposes that the Commission must seek to persuade third countries to prepare similar registers.⁶⁹ In 2012, the Commission furthermore recommended how the EU, with the help of the Member States, must implement measures to encourage third countries to apply minimum standards of good governance in tax matters.⁷⁰ This means, i.a., that these third countries must ensure that "... *ownership and identity information for all relevant entities and arrangements is available to its competent authorities*", and likewise there is an obligation to ensure that this information can be exchanged with the Member States' authorities.⁷¹

In conclusion it may be said that even though the EU still has to adopt the revised Money Laundering Directive, there are signs of enhanced transparency so information about the people who control the companies formed in the EU become available (at least for the authorities). It will, however, be a challenge to ensure that the information about the beneficial owners always is available and updated. Next, it becomes a challenge to extend this initiative to third countries.

4.5. Taxation of transfers between companies

From above, it already appears that the tax area has faced problems with companies being used to hide revenue and property from the tax authorities. But in addition, tax law has also experienced problems with another type of letterbox companies. Here the purpose is not to hide any activity or assets but on the contrary that companies are used to implement a limited activity which the tax authorities may not want to recognise as a real activity.

This is for example the case with the so-called conduit companies. These are companies which are used for transferring funds (for example dividends) from a subsidiary to a parent company via an intermediate holding company (the conduit company) which has been established in a third country. The aim is to exploit favourable tax rules in the country in which the conduit company is situated - typically a favourable double taxation treaty with third countries. In the EU, the so-called "Parent-subsidiary Directive" ensures tax-free distribution of dividends from a subsidiary in one Member State to a parent company in another Member State.⁷² If the ultimate parent company is situated outside the EU, it is not possible to obtain tax exemption according to the directive, but it is possible to transfer the money through a conduit company situated in a Member State, which has a double taxation treaty with the third country in question, which ensures a low taxation on the further distribution of dividends to the ultimate parent company. This raises the question whether the tax authorities should acknowledge the conduit companies, or whether they instead can choose to disregard the conduit companies having the consequence that the payment can be levied taxes as if it was carried out directly between the subsidiary and the ultimate parent company. Such conduit companies have caused many discussions in several Member States.

The real issue is whether conduit companies have sufficient substance to be recognized as the beneficial owner of the profit, and here the problem has many features in common with that encountered with letterbox companies in other areas. Besides being a problem that affects several Member States, it is also a

⁶⁹ Cf. article 29(2a) of the proposal

⁷⁰ Cf. C(2012) 8805.

⁷¹ See para. A1 of the recommendation.

⁷² Directive 2011/96/EC.

problem that affects EU law as it is obvious that measures towards conduit companies must respect the EU directives⁷³ and furthermore not are allowed to constitute a restriction on the right of establishment.⁷⁴

Under the heading "Commission starts fight against letter-box companies"⁷⁵ the Commission proposed a change to the Parent-Subsidiary Directive in November 2013 which intends to make it easier for the Member States to combat certain types of tax fraud and tax evasion.⁷⁶ The directive already includes a clause on abuse but according to the Commission, this provision is unclear and may cause confusion.⁷⁷ The new provision specifies that the Member States shall withdraw the benefit of the directive in case of an artificial arrangement or an artificial series of arrangements. An artificial arrangement is an arrangement which is not a reflection of the economic reality but has been "*put into place for the essential purpose of obtaining an improper tax advantage under this directive and which defeats the object, spirit and purpose of the tax provisions invoked*".⁷⁸ In addition, the proposed directive lists a number of situations which the Member States should ascertain when determining whether an arrangement is artificial. These are:⁷⁹

- (a) *the legal characterisation of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole*
- (b) *the arrangement is carried out in a manner which would not ordinarily be used in a reasonable business conduct*
- (c) *the arrangement includes elements which have the effect of offsetting or cancelling each other*
- (d) *the transactions concluded are circular in nature*
- (e) *the arrangement results in a significant tax benefit which is not reflected in the business risks undertaken by the taxpayer or its cash flows."*

The provision indicates when activities taking place in a company has an artificial nature. It does not try to define any minimum requirement as to what constitutes an establishment or which documents, facilities etc. must be present for a company to be recognized as entitled to benefit from the directive. This is due to the fact that many companies operating as part of a larger group structure often have relatively limited activities, and therefore defining minimum requirements to the activities may not work to distinguish between the companies that are part of an artificial arrangement and those who are not. Instead it is defined whether the activities taking place in the company has a real or an artificial aim.

4.6. Authorisation of financial institutions

⁷³ In addition to the above-mentioned Parent-subsidiary Directive, similar problems arise in connection with distributions covered by the Interest/Royalty Directive (Directive 2003/49/EC).

⁷⁴ See Maikel Evers and Arnaud de Graaf, 'Limiting Benefit Shopping: Use and Abuse of EC Law', *EC Tax Review* 2009 pp. 279-298 and Martin Poulsen, 'Gennemstrømningselskaber i EU – misbrug eller lovlig skatteminimering?', *Skat Udland*, 2008, 89.

⁷⁵ See notice from the Commission dated 26 November 2013 published on www.euractiv.com. In this notice, Commissioner Semeta also suggests a Common Consolidated Corporate Tax Base in the fight against letterbox companies. See similarly Freek PJ Snel, 'What Is Wrong with (The Rules of) the Game?', *Intertax* 2013 pp. 614-620.

⁷⁶ COM (2013) 814.

⁷⁷ Cf. COM (2013) 814, p. 3.

⁷⁸ See the new Article 1a(1) proposed.

⁷⁹ Cf. the proposal for the new article. 1a(2).

Over the year the EU has established a system whereby financial institutions operating in the EU should be authorised in a Member State and be subject to supervision in that Member State. Given this is done the institution should be allowed to exercise the authorised activities in all Member States under the principle of home-state control.

If a company is allowed to seek authorisation in any Member State of its own choice, this may make it difficult for the authorities to exercise an effective supervision. Therefore, if a credit institution is a company it is required to be registered in the Member State where it applies for authorisation, and furthermore it should have its head office in the same Member State. This requirement was introduced in the banking harmonisation with the “Post BCCI-directive”.⁸⁰ This directive was a reaction to the fact that BCCI (Bank of Credit and Commerce International) avoided effective supervision in the late 80s and early 90s because its centre for management was in London and its place of incorporation was in Luxembourg.⁸¹ The requirement of registered office and head office in the same Member State is now found in several directives regulating different types of financial institutions.⁸²

The directive does not define what constitutes a head office. Already for that reason it may be difficult to enforce – uniformly – throughout the EU. Furthermore, ensuring that the company has its head office in the Member State where it is subject to supervision may not be enough since the main activities of the company may be situated in other Member States and may therefore be difficult to supervise. This problem has been addressed in the preamble in several of the directives regulating financial institutions. For credit institutions para. 16 of Directive 2013/36/EC states:⁸³

“The principles of mutual recognition and home Member State supervision require that Member States’ competent authorities should refuse or withdraw authorisation where factors such as the content of the activities programme, the geographical distribution of activities or the activities actually carried out indicate clearly that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within whose territory it carries out or intends to carry out the greater part of its activities. Where there is no such clear indication, but the majority of the total assets of the entities in a banking group is located in another Member State, the competent authorities of which are responsible for exercising supervision on a consolidated basis, responsibility for exercising supervision on a consolidated basis should be changed only with the agreement of those competent authorities.”

The intention here is clearly to avoid a situation where a credit institution may attempt to avoid effective supervision in the Member States where it performs most of its activities by setting up a company and its head office in another Member State and apply for authorisation there. Instead of trying to define what

⁸⁰ Directive 95/26/EC.

⁸¹ On the BCCI scandal and its implications see Daniel M. Leifer, ‘Putting the super back in the supervision of international banking, post BCCI’, 60 *Fordham Law Review* 1991-1992 pp. 467-500.

⁸² Apart from the latest directive on credit institutions (Directive 2013/36/EC, Article 13(2)(a)), the requirement is also found in Directive 2009/138/EC on insurance and reinsurance (Solvency II), Article 14(2)(a), Directive 2009/65/EC on collective investment in transferable securities (UCIT), Article 7(1)(d) and Directive 2011/61/EC on alternative investment fund managers (AIFM), Article 8(1)(e).

⁸³ It seems that the origin of this paragraph is para. 8 of the Second Banking Directive (Directive 89/646/EEC). A very similar paragraph is found in the preamble to the UCIT-directive (Directive 2009/65/EC, para. 73).

constitutes an establishment, the preamble defines how it should be decided where a company has its closest connection and therefore should be subject to supervision.

5. Combating letterbox companies - approaches and effects

5.1. Letterbox companies as a challenge to the internal market

As the analysis shows, the undesirable use of letterbox companies is not necessarily an issue which is connected to the internal market. Especially the problems concerning misuse of companies for certain types of crime have no direct connection with the establishment of the internal market. However, there are certain problems with letterbox companies which are closely connected to the establishment of the internal market. This is illustrated by the problems with the posted workers and the road transport sector, and to some extent the problems caused by conduit companies.

Looking at how letterbox companies may be misused, the examined cases show that this can be done in different ways. In some cases - as illustrated by the posted workers case and the case involving the road transport sector - it is a problem that letterbox companies are not really established in the Member States in which they are registered, but on the contrary have placed their activities in another Member State. The intention is to avoid the full impact of the legislation in the Member States where they operate. In the case of financial institutions the original problem was that the institutions may try to subject themselves to supervision in a different Member State than the one where they have their head office or main activities. Also in this case their intention is to avoid the full impact of regulation. The problem with the conduit companies is that the companies do not have any activities of importance in any Member State, but they are used for a limited activity where the company sometimes represents a superfluous link solely inserted in order to minimise the tax. The companies used for different types of crime also normally have limited activities, but what is problematic in these cases is the fact that the companies are used to hide from the authorities what is happening and who is behind the company.

5.2. How to regulate letterbox companies

The examples reviewed in section 4 indicate that the problems with the letterbox companies are very different, and thus it has been difficult to make a general initiative to combat all these types of misuses. Instead, the EU has decided to solve the problems in the sectors where they appear, which seems to be an appropriate strategy. As already mentioned in section 3, it seems difficult to agree on initiatives which on a broader scale counter the undesirable use of letterbox companies. The reason being mainly that letterbox are not always undesirable, but have also played an important role in forming an internal market for companies and for the approximation of company law through regulatory competition.

The sector-specific strategy which is followed in combating undesirable use of letterbox companies seems to consist of four tracks:

5.2.1. Defining letterbox companies

Firstly, there have been different attempts to define how to identify whether it is a letterbox company. In the case of posted workers and the road transport sector it has been specified how to determine that it is a

genuine establishment. In both cases indicators have been set up regarding which actual and legal matters to emphasize in connection with this assessment.

In fact it should be superfluous as it is already clear that companies which not actually have been established in another Member State cannot claim status as a service provider. It follows from the Service (Directive 2006/123/EC), Article 4(2), that a service provider is a company which is established in a Member State. Thus, a letterbox company without any establishment may not invoke the Directive.⁸⁴ An establishment is in the same directive Article 4(5) defined as "*the actual pursuit of an economic activity [...] for an indefinite period and through a stable infrastructure from where the business of providing services is actually carried out.*" According to para. 37 of the preamble to the Directive, this definition intends to follow the definition laid down by the Court. Furthermore, it says: "*According to this definition, which requires the actual pursuit of an economic activity at the place of establishment of the provider, a mere letter box does not constitute an establishment.*"⁸⁵ The definition given in Article 4(5) is fairly broad and difficult to apply in specific cases. For this reason it is valuable that secondary legislation is used to indicate more specific criteria for what it takes to be established, taking into account the special feature of the industry and taking into account the nature of the abuse. Such definitions are much more likely to be enforced by the Member States and also it is more likely that several Member States may come to the same conclusion about where a company is established.

A different approach is used in the directives regulating financial institutions as they have indicated where the substantial activities are conducted and where, as a consequence, the institution should be subject to authorisation and supervision. This approach seems further than combating letterbox companies as also companies with some activities in the state of incorporation will be affected if the majority of their business is placed in another Member State.

In relation to the Parent-Subsidiary Directive it has instead been decided to indicate elements which should help decide whether there is an artificial arrangement. Once again it seems to reflect that the Court's broad definition of an artificial arrangement is difficult for Member States to work with. It may be questioned, however, whether the fairly open criteria, which the Commission suggests in its amendment to the Parent-Subsidiary Directive, is precise enough to help the Member States.⁸⁶ Therefore, more guidelines may be needed in this area.

5.2.2. Collecting information on letterbox companies

Secondly, attempts have been made to make it easier to gather information about letterbox companies in the Member State in which they have been established. In the new Posted Workers Enforcement Directive specific rules have been introduced to ensure that Member States can contact the Member State where the potential letterbox company is established to make the Member State investigate whether there is a real establishment. However, several different regimes have been set up within the EU to get assistance

⁸⁴ See also Paschalis Paschaldis, *Freedom of Establishment and Private International Law for Corporations*, 2012 p. 105.

⁸⁵ This statement may not fully comply with the *Centros*-judgment as it presupposes that a letterbox company does not have any rights under the Treaty. This is not the case since *Centros* established that even a letterbox company may exercise free movement.

⁸⁶ Also Jakob Bundgaard, 'Supranational modvirkning af dobbelt ikke-beskatning og anden skatteplanlægning', *Skat Udland*, 2014, pp. 95-100.

from other Member States to carry out investigations and to exchange information. It is thus possible to use the European Business Register (EBR) and the Internal Market Information System (IMI).⁸⁷ Regarding taxation there is also a directive which paves the way for exchange of information between the Member States,⁸⁸ and likewise there are databases with information about VAT registration in the various Member States.⁸⁹ More broad-based directives such as the Service Directive⁹⁰ and the Money Laundering Directive also allows for an exchange of information.⁹¹

But information can only be exchanged if you have access to it. In many Member States it is easy for shareholders and even directors to keep their identity hidden from the authorities, and in such cases exchange of information is impossible. Thus, it is interesting that the proposal for a revised Money Laundering Directive suggests that the Member States register the beneficial owners of all companies in the EU. This information either has to be available at the company so the authorities can ask for it or available at a central register. According to the Parliament's proposal it even has to be publicly available. All proposals will ensure further exchange of information between the Member States. As mentioned above it will certainly be a challenge to ensure that the beneficial owners at all times actually are registered. Effective sanctions are therefore needed. In addition, it can be questioned if it is not necessary to limit the option of issuing bearer shares, which, among other things, Germany and the UK consider, and to take action to limit the use of nominee directors as well as corporate directors, which the UK is about to do.⁹² In their proposal for a revised Money Laundering Directive the Parliament also suggests that Member States should be obliged to "...establish effective anti-abuse measure with view to preventing misuse based on bearer shares and bearer share warrants".⁹³ Such initiatives will make it more difficult for the beneficial owners to hide. In its latest action plan on company law the Commission has notified an initiative to improve the transparency of who owns shares in listed companies, but it does not seem to have plans about further initiatives to ensure transparency in unlisted companies.⁹⁴

5.2.3. Collaborating on the enforcement

The *third* track is still in its infancy. According to the cases in the road transport sector, it may be a good idea to clarify which obligations the Member States, in which the letterbox companies are claimed to be established, have to control whether there is a genuine establishment, and to control whether the

⁸⁷ See more about this http://ec.europa.eu/internal_market/imi-net/index_en.htm.

⁸⁸ Cf. Directive 2011/16/EC. See further Dennis Weber (ed.), *European direct taxation*, 2011 pp. 599-674 and Roman Seer, 'Recent Development in Exchange of Information within the EU for Tax Matters', *EC Tax Review* 2013 pp. 66-77.

⁸⁹ The so-called VIES system. A so-called "European Tax Identification Number", cf. COM (2012) 722 is also intended to be introduced.

⁹⁰ See Article 29 of Directive 2006/123/EC.

⁹¹ For an analysis of the different rules ensuring administrative cooperation between Member States, see Francois Lafarge, 'Administrative Cooperation between Member States and Implementation of EU Law', *European Public Law* 2010 pp. 597-616.

⁹² The G8 countries' action plans for follow-up of the declaration they have adopted is available on the following website: <http://star.worldbank.org/star/about-us/transparency-beneficial-ownership-resource-center>. The more detailed UK program is found in the report by the Department for Business Innovation & Skills, *TRANSPARENCY & TRUST: ENHANCING THE TRANSPARENCY OF UK COMPANY OWNERSHIP AND INCREASING TRUST IN UK BUSINESS*, April 2014.

⁹³ See Article 29(2a) in the resolution adopted by the European Parliament on 11 March 2014.

⁹⁴ Cf. COM(2012), 740 pp. 7-8. Interestingly it seems that the Commission suggests that it should still be possible for those who own bearer shares to be anonymous.

companies in other ways are used for undesirable purposes. The Member State of establishment is not the one which is affected by the abusive activities of the letterbox company and therefore that Member State's incentive to counter them may be inadequate.⁹⁵

Member States have a duty of sincere cooperation according to Article 4(3) TEU. What this principle more specifically requires of the Member States is, however, doubtful,⁹⁶ and it is consequently doubtful to what extent this duty obliges the Member States to take steps to hinder that the companies' incorporation in that Member State is misused for activities in other Member States. As mentioned in section 2.3, there is a general jurisprudence confirming that EU law may not be abused. This could indicate that Member States should help to ensure that the companies do not abuse the right of establishment or the freedom to provide services. However, it is not clear whether the principle prohibiting abuse does in fact oblige the Member State to take action to prevent abuse, or whether it just allows Member States to do so if they so desire. The Court's jurisprudence is not clear on this point.⁹⁷ Experience shows that Member States so far have taken few steps to prevent that letterbox companies incorporated in that Member State is misused for activities in other Member States.

It seems more likely that the Member States have a duty to ensure that secondary legislation is not abused. Thus, it is clear that the Commission finds that Member States have a duty to ensure that road transport operators established in that Member State is actually fulfilling the requirement in Article 5 of Regulation 1071/2009 see section 4.2. Also it may be that the provision on tax evasion in the Parent-Subsidiary Directive may require the Member State to fight tax evasion.⁹⁸ However, even if it is established that there is a duty to help fighting abuse by letterbox companies in areas where there is secondary harmonisation, the duty is still of a general nature and it may be needed to indicate more precisely what the Member State should do in this regard. A first attempt was made in Regulation 1071/2009/EC by stating that the Member States every five years should make sure that the conditions of a real establishment is fulfilled, see Article 12. However, more detailed rules may be needed. At least it should be made clear that the Member State should take active steps to investigate possible abuse of a company when requested to do so by other Member States and maybe other institutions like trade unions.

5.2.4. Liability for those using or facilitating letterbox companies

Fourthly, steps have been taken to try to extend liability to those who are responsible for using letterbox companies in an abusive way. The Member States are obliged to introduce effective sanctions to ensure that the secondary legislation is complied with. But this does not necessarily mean that liability is extended beyond the letterbox company to include those responsible for setting up or managing the letterbox

⁹⁵ In the end, however, it may damage the Member States' reputation if they permit letterbox companies to be used to circumvent the legislation in other states. This also explains why the UK wants to make a greater effort to prevent UK letterbox companies from being used for different types of abuse, and likewise the Netherlands seem to take steps to avoid Dutch letterbox companies from being used for tax speculation, see the article dated 9 September, 2013 by Finfacts Team, 'Netherlands to renegotiate tax treaties, reform tax haven company rules', available on www.finfacts.i.e.

⁹⁶ See Francois Lafarge, 'Administrative Cooperation between Member States and Implementation of EU Law', *European Public Law* 2010 pp. 597-616.

⁹⁷ See the discussion in Karsten Engsig Sørensen, 'Abuse of rights in Community law: A principle of substance or merely rhetoric', *Common Market Law Review*, 2006, pp. 423-459, at p. 440.

⁹⁸ This point is made by Dennis Weber, 'Abuse of law', *LIEI* 2004 pp. 43-55.

company. The Parliament's proposal for an amended Money Laundering Directive suggests that national or legal persons that do not comply with the disclosure requirement suggested in Article 29 of the Directive should be imposed an effective, proportionate and dissuasive penalty.⁹⁹ Since it is the company that should collect and transmit the information on who is the beneficial owner, this implies that the company and its management should be subject to sanctions if they fail to make sure of this. However, possibly the proposal by the Parliament also aims to ensure that the Member States impose sanction on those who are beneficial owners but have failed to disclose this fact. If this is the case, the directive may impose a liability on those who try to hide behind a letterbox company.¹⁰⁰

The newly adopted Enforcement Directive does also hint at a liability extending to those using letterbox companies. As explained, paragraph 42 of the preamble suggests that Member States should investigate the identity of the persons responsible for the posting in the situation where a service provider is not established in the Member State of establishment. This seems to indicate that the Member States also should try to impose sanctions on those responsible, but the directive does not explicitly require this. There is a general duty to adopt penalty rules according to Article 20 of the Directive but no explicit mentioning on whom should be the subject of these penalties. However, to the extent possible Member States do introduce sanctions against those responsible for misusing letterbox companies, the Directive allows for a mechanism to ensure cross-border enforcement of administrative penalties and/or fines, see Articles 13-19 of the Directive.

The Enforcement Directive also allows for a subcontractor liability. However, this liability is not directed at those responsible for using the letterbox company and therefore has a different nature. Imposing such a liability on those who use subcontractors will give these an incentive to ensure that the subcontracting company is indeed a financially solid company likely to be able to pay its workers. This may also make it difficult to use letterbox companies but the primary aim seems to ensure that the workers are protected and to prevent illegal or unfair business competition.¹⁰¹

Finally, it should be noted that the UK plans to amend its rules on disqualifications of directors to allow for a broader definition of what is to be considered relevant when deciding whether a person is to be disqualified. Furthermore, courts are required to take any overseas misconduct into account when deciding whether a person should be disqualified. Therefore, if a UK company is used as a letterbox company for misconduct in other Member States, it may now be possible to have the director of the company disqualified in the UK.¹⁰² This step is helpful in overcoming some of the problems with cross-border enforcement of disqualification of directors.¹⁰³

⁹⁹ See Article 29(2a) of the Parliament's proposal adopted on 11 March 2014.

¹⁰⁰ Interestingly the UK has decided to implement criminal offences where individuals or companies fail to provide beneficial ownership information or provide false information, see Department for Business Innovation & Skills, *TRANSPARENCY & TRUST: ENHANCING THE TRANSPARENCY OF UK COMPANY OWNERSHIP AND INCREASING TRUST IN UK BUSINESS*, April 2014 p. 38.

¹⁰¹ For an analysis of the existing national rules on subcontracting liability, see European Foundation for Improvement of Living and Working Conditions, *Liability in subcontracting processes in the European constructing sector*, 2008.

¹⁰² See Department for Business Innovation & Skills, *TRANSPARENCY & TRUST: ENHANCING THE TRANSPARENCY OF UK COMPANY OWNERSHIP AND INCREASING TRUST IN UK BUSINESS*, April 2014 pp. 52-70.

¹⁰³ For an analysis of these problems, see Karsten Engsig Sørensen in Hanne Birkmose, Mette Neville and Karsten Engsig Sørensen (eds.), *Boards of Directors in European Companies*, 2013 pp. 327-348.

Alternatively, attempts could be made to regulate the agents offering sale of companies.¹⁰⁴ Looking at the internet, there is hardly any doubt that they contribute to make it very easy to form a letterbox company, and sometimes perhaps also inspire to the use of these. An action against these will, probably be very difficult because it is complicated to conduct an action only targeted at the unhealthy part of the industry and not the majority of the agents' activities which only aims at helping entrepreneurs and others to make legitimate use of the corporate form.

5.2.5. Requirement as to the location of the head office and main activities

Finally and *fifthly* the harmonisation of financial institutions has adopted the requirement that the head office of the company should be in the state of incorporation. This requirement seems to duplicate the requirement of the SE-Statute Article 7.¹⁰⁵ Just as it was the case with the SE-Statute, the requirement has been introduced without a definition of what constitutes a head office and therefore it may be difficult to apply. The requirement should, however, ensure that a company cannot be without any activities in the state of incorporation and as such it is an effective remedy against letterbox companies. However, the fact that the company has some head office functions in the state of incorporation may not always be enough to ensure that the company does not disrupt the proper working of the internal market. Therefore, to ensure an effective supervision of financial institutions, the requirement has been supplemented by a principle that a company should not be authorised if the distribution of business activities indicates that the company is trying to avoid stricter rules in another Member State. This evidently is also a very difficult test to apply, and therefore may not be the best way forward. Also a requirement that a company should be incorporated in the state where it has its main business does not sit well with the CJ case law.¹⁰⁶

6. Concluding remarks

After several years where letterbox companies have been, if not promoted, then accepted in the EU, it seems that steps are now taken to encounter letterbox companies where they are interfering with the functioning of the internal market. Instead of trying to find a more general solution, the problem has been approached on a more selective basis in the areas where problems have occurred. This has been done by introducing secondary legislation supporting the effort of the Member States to hinder abuse of companies in specific sectors and for specific fraudulent purposes.

As the analysis shows, there are, however, certain common features in the regulation. Several attempts have been made to define the elements which make the use of letterbox companies abusive and initiatives which allow for the exchange of information and cooperation between Member States. Limited attempts have also been made to make it clear which steps Member States should take to hinder abuse by letterbox companies, including rules extending sanctions to those responsible for the abuse.

These examples may serve as models for how letterbox companies may be addressed in secondary legislation in other sectors if the need may arise. It is more doubtful whether they may serve as a template

¹⁰⁴ Cf. Jason Sharman, 'Preventing the misuse of shell companies by regulating corporate service providers', *U4 BRIEF*, 2013:7, pp. 1-4.

¹⁰⁵ See section 3.

¹⁰⁶ See section 2.2.

for a more general legislative initiative to hinder letterbox companies obstructing the internal market. It seems that the way letterbox companies may be misused differs very much from sector to sector and this makes a sectorial approach more likely to succeed. However, given that exchange of information and other types of administrative cooperation between Member States is a common feature to combat abuse by letterbox companies, it may be possible to make a broader initiative to ensure such cooperation. Given that the companies' registers will be shortly interconnected, it seems that the potential for a close collaboration between the companies' agencies in the Member States may be a logical next step.