SYNDICAT EUROPEÆN TRADE UNION

ETUC Position on preventing the use of Shell Entities

Adopted at the virtual Executive Committee Meeting of 16-17 March 2022

Key messages

- The ETUC is very concerned about the use of shell entities for the circumvention of tax, social security and employment obligations, and criminal activities. This phenomenon is the consequence of an internal market that does not comprehensively regulate corporate tax, complex business structures, social and labour rights and company mobility.
- A Directive addressing the misuse of EU-based shell entities is a step in the right direction. To be most effective, it should not exclusively be used for tax purposes but also to address the social impact of shell entities.
- The ETUC calls for a Directive that addresses more comprehensively the interface between tax and social policies. In particular, the presence of a substantial part of the workforce must be recognised as key element of a company's economic activity.
- Furthermore, the information collected by tax authorities in the context of this Directive must be made accessible to other enforcement authorities and to the public, so as to facilitate targeted labour inspections and ethical public procurement policies, and to enable workers to ascertain their rights.
- The sectoral exemption for EU based investment and pension funds is counterproductive.
- Overall, the ETUC recalls the importance of a fundamental reform to combat incentives for shell companies. This implies switching from transfer pricing rules to unitary taxation, and a 25% minimum tax rate. Furthermore, the adoption of the real seat principle in European company law is long overdue.

Introduction

On 22 December 2021, the European Commission published a proposal for a Council Directive laying down the rules to prevent the misuse of shell entities for tax purposes (referred to as ATAD3)[1]. The objective is to tackle tax avoidance done through companies that do not perform any actual economic activity. It comes in response to the calls for tougher and more coherent action against corporate tax avoidance by the European Parliament and civil society.

This position paper first recalls ETUC findings on shell entities/ letterbox companies. As complex company group structures often serve multiple purposes, tax avoidance usually couples with exploiting workers. For this reason, the ETUC is concerned about the narrow focus of the proposed Directive and calls on the EU institutions to ensure that tools to tackle the misuse of shell entities for tax avoidance also serve to counteract cost-cutting labour practices.

The need for a holistic approach to tackle letterbox practices

A shell entity, also referred to as letterbox company, is a company that does not perform any actual economic activity. This increasing phenomenon is of major concern for the ETUC. Companies without economic substance are often set up with the intention of circumventing legal obligations on tax and anti-corruption, but also employment law and social security.

[1] *COM (2021) 565 final*

From a tax perspective, shell entities facilitate the transfer of corporate profits (or other types of income) made in high tax countries to countries where they would be taxed at a lower rate. The Commission estimates the foregone tax revenue through the use of shell companies in a range between €23 and €50 billion per year. From a worker's perspective, profit shifting means that liquidity are taken away from the workplace, where workers create value, and is stored in low tax countries. Cash is then no longer available for productive investment, employment and higher wages.

Shell entities are also a major driver for unfair competition on wages and working conditions as they allow businesses to take advantage of labour differentials in the internal market. As part of a project on letterbox-type practices, in 2016 the ETUC published several case studies illustrating how companies outsource labour intensive tasks to letterbox companies in order to exploit workers[2]. By setting up artificial structures in low demanding countries, companies are able to circumvent their responsibilities as direct employers with regard to wages, working hours, sick pay and social security contributions. Shell entities also undermine workers' rights to information, consultation and board level representation when company boards are transferred to a country with less progressive legislation whilst the geographical location of the workforce remains unchanged.

A handful of EU instruments, especially in the labour law field, attempt at limiting the impact of shell entities. However, these efforts are undermined by the tensions with EU economic freedoms as well as a lack of coherence with other areas of EU competence[3]. For example, the Posted Workers Directive and the Social Security Regulations contain detailed substance requirements to try to ensure that there is genuine employment in the Member State of alleged establishment. Yet, these instruments do not address the root cause of the problem as the registration of companies without economic substance remains lawful under EU law.

The 2019 Company Law package, which seeks to facilitate the mobility of companies within the internal market, recognises, in principle, the importance of tackling shell or front companies set up for the purpose of circumventing EU or national law. Some anti-abuse provisions have been introduced and Member States are expected to look at indicative factors, including economic activity and habitual place of employees. Yet, the final Directive does not provide strong control nor enforcement measures. Considering that the verification of real activities is today almost non-existent in countries of incorporation, the Company Law package is likely to be insufficient in tackling letterbox practices.

As a result, the ETUC has been calling for a holistic approach to address artificial business constructions. The interface between labour, company and tax laws must be improved. A real seat principle in company law is a long standing trade union demand: a company should only be able to register in a country where it has genuine economic operations, measured in particular by the presence of a substantial part of the workforce. As far as enforcement is concerned, the investigations already conducted by tax authorities to determine whether a corporate entity has material substance must be considered as good practices for all public authorities.

It is in this context of mismatch between labour, company and tax regulations that the ETUC analyses the recent Commission's proposal on shell entities.

A Commission's proposal that deepens the silo thinking

The Commission's proposal on the misuse of shell entities puts forward a series of criteria for Member States to identify entities without economic substance. Cross-border companies considered "at risk" are required to report on their economic activity by

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[2] Letterbox-type practices: avoiding taxes and exploiting workers across the EU | ETUC

[3] EU Company Law, Artificial Corporate Entities and Social Policy, ETUC 2019

providing information on a series of indicators. The existence of physical premises and active bank accounts would always have to be established. A third indicator would either be the genuine tax residency of directors or the tax residency of the majority of the employees. Furthermore, a company may rebut the presumption that it is a shell entity and misused for tax purposes by providing concrete evidence that there are commercial (i.e. non tax) reasons for not directly employing workers.

As a result, it would be possible for a company to satisfy a substance test even in the absence of a workforce. Employees hired through letterbox companies to perform work in other Member States' territories would not be considered as an abusive practice. As such, the Commission's proposal goes against the long standing trade union demand that a company's residency has to coincide with the habitual place of work of a substantial part of its workforce.

In the explanatory memorandum of the proposal, the Commission argues that there is a broad agreement between all stakeholders on the importance of directors' residency in the same country where the entity is located but that there is no wide agreement on the pertinence of the number of employees. The representability of the Commission's public consultations is a constant point of concern. Out of the 49 feedback entries during that particular process, nearly 70% came from business associations as well as individual companies. In contrast, the ETUC response accounts for less than 4%, though it was submitted on behalf of 92 trade unions centres in 39 countries plus 10 European trade union federations[4].

Under the Commission's proposal, denial of tax benefits would kick in if a shell entity is identified. The Member State of residence of the shell entity would not issue a tax residence certificate at all or will issue one with a warning statement. The proposal does not give any consideration to the obvious interaction with the Company Law package, where Member States are expected to issue conversion certificates if they are satisfied that there is no abusive practice for the purpose of tax or labour law circumvention. The proposal makes no reference either to consequences if the shell entity breaks other EU legal obligations, such as the substance requirements in the social security regulations and the posted workers Directive.

Finally, the proposed Directive contains provisions for facilitating communication between all EU tax authorities. All information on EU shell companies will be automatically exchanged through a central directory. The creation of this central directory has the potential of significantly boosting targeted audits and enforcement. However, as the Directive exclusively targets tax authorities, there is no reason to believe that this information will be accessible to other law enforcement departments in spite of this information being crucial for the purpose of labour inspections.

ETUC demands – the need to address the social impact of shell entities

The ETUC calls on the EU institutions to address the impact of artificial business entities on workers as well as tax revenues. Whilst corporate tax avoidance may remain the central element of the Directive, its final provisions must also reinforce – and not undermine – the anti-abuse provisions contained in EU labour, social security and company law.

First, the protection of workers' rights must be expressly included in the objectives of the Directive on shell entities.

Second, the presence of a significant part of the workforce must become a decisive criterion for determining substance. Conversely, a split between the registered seat and the real seat must become an indicator of a shell company. As employees are a key

[4] Fighting the use of shell entities - consultation outcome

element of a company's value creation, it is unacceptable that they continue to be disregarded as an indicator of economic activity.

Third, the information collected by tax authorities, in the context of the Directive, must be made accessible: to labour authorities so as to facilitate targeted labour inspections; to workers and their representatives to strengthen information, consultation and collective bargaining rights; to public authorities to take an informed decision on awarding public contracts to private companies; and more generally to the public to strengthen scrutiny. Careful consideration should be given to the possible role of the European Labour Authority when carrying out social audits on the basis of tax information, also ensuring the involvement of social partners who are already involved in the fight against undeclared work.

Overall, the ETUC recalls the importance of dealing with the root of the problem; not just the consequence. The ETUC renews its calls for a substantial reform of transfer pricing rules towards unitary taxation, according to which a company group is treated as a single and coherent entity – as opposed to an aggregation of fictionally autonomous subsidiaries/ establishments. Furthermore, the real seat principle must be recognised in the whole of the EU acquis. It should not be possible for a company to have legal existence if it does not carry, or intend to carry, genuine economic activity.

Importantly tax authorities must be much better resourced and equipped to be able to implement and enforce the directive.

The ETUC renews its call for the adoption of a common corporate tax base, based on unitary taxation and a 25% common minimum corporate tax rate and the enforcement of the recently adopted directive on public country-by-country reporting, which will allow some degree of scrutiny on corporate tax structures and payments.