



An overview of shell companies in the European Union

STUDY

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Authors: Ivana Kiendl Krišto and Elodie Thirion
Ex-Post Evaluation Unit and European Added Value Unit
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Study

In April 2018, the European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) asked the European Parliamentary Research Service (EPRS) to produce a study on shell companies in the European Union, the main common feature of which is the absence of real economic activity in the Member State of registration.

Prepared by the Ex-Post Evaluation Unit (EVAL) and the European Added Value Unit (EAVA) of EPRS, this study aims to contribute to a better understanding of the phenomenon of shell companies by seeking to estimate the incidence of such companies, by means of a set of 'proxy' indicators at Member State level. It also explains the main risks associated with shell companies and current policies aimed at mitigating the risks identified.

AUTHORS

Ivana Kiendl Krišto, Policy Analyst, Ex-Post Evaluation Unit

Elodie Thirion, Policy Analyst, European Added Value Unit

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To contact the authors, please email: EPRS-ExPostEvaluation@ep.europa.eu or EPRS-EuropeanAddedValue@ep.europa.eu

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eprs@ep.europa.eu

<http://www.eprs.ep.parl.union.eu> (intranet)

<http://www.europarl.europa.eu/thinktank> (internet)

<http://epthinktank.eu> (blog)

Executive summary

This paper aims to contribute to a better understanding of the phenomenon of shell companies in the European Union. It has been written in response to a request from the European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) from April 2018.

The term 'shell company' has been used widely in recent years, often interchangeably with terms such as 'letterbox company', 'mailbox company', 'special purpose entity', 'special purpose vehicle' and similar. However, these terms do not necessarily always refer to the same thing. A literature review reveals that shell companies are defined differently in different contexts.

For the purpose of this paper, 'shell' companies fall broadly into one of the following three categories: 'anonymous shell companies', 'letterbox companies', and 'special purpose entities'.

Anonymous shell companies: this type of 'shell' company provides anonymity as a key element, while simultaneously guaranteeing control over the shell company and its resources. The ultimate beneficial owner (UBO) remains hidden behind this company, or behind a chain of interconnecting shell companies, often in several jurisdictions. This type of company has featured prominently in many International Consortium of Investigative Journalists (ICIJ) reports over the past years, not least those based on the Panama Papers leaks. Such companies are often mentioned in relation to tax evasion, corruption, money laundering and terrorist financing.

Letterbox companies: this second type of 'shell' company, also referred to as a 'mailbox' company, is generally a company registered in one Member State while its substantive economic activity takes place in another Member State. These companies are sometimes used to circumvent labour laws and social contributions in the Member State in which the substantive economic activity is taking place. These 'letterbox' or 'mailbox' companies are generally mentioned in the context of circumvention of the Posting of Workers Directive.

Special purpose entities (SPEs): this third type of 'shell' company refers to entities whose core business consists of group financing or holding activities. These are entities with no or few employees, little or no physical presence in the host economy, and whose assets and liabilities represent investments in or from other countries. In this context, SPEs are usually mentioned with regard to their possible use in aggressive tax planning.

The main common feature of the above three types of shell company is the absence of real economic activity in the Member State of registration. This generally means that such companies have no (or few) employees and/or no (or little) production and/or no (or little) physical presence in the Member State of registration.

Reliable data on shell companies is not however available, especially in the case of the first two categories. That is why this study approaches the problem by looking for proxies as possible indicators of the presence and magnitude of shell companies in the EU, on the basis mainly on macroeconomic indicators. These indicators are: the number of foreign-owned companies in a Member State; the ratio of foreign direct investment (FDI) to a Member State's gross domestic product (GDP); and the profitability gap between foreign and domestic companies in a Member State.

It is worth noting that the use of shell companies can be legal. Shell companies do not necessarily bear risks because of what they are. However, when associated with anonymity, circumvention of the Posting of Workers Directive or treaty abuse, they can be misused and thus entail serious risks of tax avoidance, tax evasion, money laundering and abuse of social rights. Such misuses of shell companies impact on the economy and society as a whole, with economic, security and social consequences.

In the past few years, the European Union has adopted a whole series of policies and legislation with the aim of addressing the above problems of tax avoidance, tax evasion, money laundering and abuse of social rights. These are presented in Section 3 of this paper.

However, these are recent moves, and many of the regulatory provisions contained in EU legislation have yet to produce their full effects, or even to come into force. In addition, several relevant legislative proposals are being negotiated at the time of writing this paper (for instance on the common consolidated corporate tax base, and on public country-by-country reporting).

It is therefore too early to assess how these recent pieces of legislation will perform on their own, and in combination with other related pieces of legislation. In the light of the interlinkage between the relevant legislative acts, the European Parliament could consider requesting a fitness check after several years of implementation of these acts. A fitness check (i.e. an evaluation of a group of interventions that have some relationship with each other) could lead to a more comprehensive picture of whether these legislative and policy interventions have performed in comparison with expectations.

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List of acronyms

AMLD	Anti-Money-Laundering Directive
ATAD	Anti-Tax-Avoidance Directive
ATP	Aggressive tax planning
BEPS	Base erosion and profit shifting
CBCR	Country-by-country reporting
CCCTB	Common consolidated corporate tax base
CDD	Customer due diligence
CFC	Controlled foreign company
DAC Directive	Directive on the Automatic Exchange of Information
EAVA	EPRS European Added Value Unit
EPRS	European Parliamentary Research Service
EVAL	EPRS Ex-Post Evaluation Unit
FDI	Foreign direct investment
FIU	Financial intelligence unit
GDP	Gross domestic product
IMF	International Monetary Fund
OCTs	Overseas countries and territories
OECD	Organisation for Economic Cooperation and Development
PANA	European Parliament's Committee of Inquiry to investigate alleged contraventions and maladministration in the application of Union law in relation to money laundering, tax avoidance and tax evasion
PWD	Posting of Workers Directive
SPE	Special purpose entity
TAXE	European Parliament's Special Committee on tax rulings and other measures similar in nature or effect
TAX2	European Parliament's Special Committee on tax rulings and other measures similar in nature or effect
TAX3	European Parliament's Special Committee on financial crimes, tax evasion and tax avoidance
UBO	Ultimate beneficial owner

1. Introduction

1.1. Scope and methodology

This paper aims to contribute to a better understanding of the **phenomenon of shell companies** in the European Union.

In the absence of reliable data, it approaches the issue through a set of 'proxy' **indicators at Member State level**. These indicators are: the number of foreign-owned companies; the ratio of foreign direct investment to gross domestic product (GDP); and profitability between foreign and local companies.

The paper further presents the **main risks** associated with the shell companies and the **policies aimed at mitigating these risks**.¹

Finally, the paper does not include within its scope trusts, foundations and similar legal arrangements. As to its territorial scope, this paper does not include those shell companies registered in EU overseas countries and territories (OCTs).²

The paper was written by means of **desk research**, relying on a wide range of publicly available institutional sources (mainly EU, OECD and IMF), as well as on academic literature, think tank publications, published books and articles in mainstream and specialised media.

1.2. What is a shell company?

The term 'shell' has been used widely in the past years, often interchangeably with terms such as 'letterbox', 'mailbox', 'special purpose entity', 'special purpose vehicle' and similar.³ However, these terms do not necessarily always cover the same thing.

A review of literature reveals that shell companies are defined differently in different contexts. For the purpose of this paper, shell companies refer to three types of shell companies in three general contexts as described below, unless specified otherwise.

Anonymous shell companies

The first category of 'shell' company has **anonymity** as a key element – such a company provides anonymity for the actual owner while simultaneously guaranteeing control over the shell company and its resources. The **ultimate beneficial owner (UBO) remains hidden** behind such a company, or behind a chain of interconnecting shell companies, often in several jurisdictions. This type of company has featured prominently in many International Consortium of Investigative Journalists

¹ This paper does not attempt to present a case study of a shell company or a legal assessment of what constitutes a shell company.

² These have been widely covered by the [PANA](#) committee. For details on OCTs, see for instance the [EPRS study](#) on Tax evasion, money laundering and tax transparency in the EU overseas countries and territories, April 2017.

³ See for instance the following publications for use of different terms: [OECD](#), Glossary of Foreign Direct Investment Terms and Definitions, 2008; OECD, Addressing Base Erosion and Profit Shifting, 2013; [European Commission](#), Smart regulation - Responding to the needs of small and medium-sized enterprises, COM(2013)122; [SOMO](#), The impact of letterbox-type practices on labour rights and public revenue, 2016; Michael G. Findley, Daniel L. Nielson, J. C. Sharman, [Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies](#), 2012; etc. In addition to the terms mentioned in the main text, other terms used include: brass-plate companies, conduit entities, passive offshore vehicles, etc.

(ICIJ) reports over the past few years, not least those based on the Panama Papers leaks. Such companies appear in the context of tax evasion, corruption, money laundering and terrorist financing.

Letterbox companies

This second type of 'shell' company is usually referred to as a 'letterbox' or 'mailbox' company. These are generally companies registered in one Member State while the substantive economic activity takes place in another Member State. Such companies are sometimes used to **circumvent labour laws and social contributions** in the Member State in which the substantive economic activity takes place. Such 'letterbox' or 'mailbox' companies are generally mentioned in the context of **circumvention of the Posting of Workers Directive**.⁴

Special purpose entities

The third type of 'shell' company, the special purpose entity (SPE), refers to entities whose core business consists of **group financing or holding activities**. These are entities with no or few employees, with little or no physical presence in the host economy, and whose assets and liabilities represent investments in or from other countries. In this context, SPEs are usually mentioned with regard to their **possible use in aggressive tax planning**. Section 2.4. provides more detail on SPEs.

The main common feature of the above three types of shell company is the **absence of real economic activity** in the Member State of registration. This generally means that these companies have no (or few) employees, and/or no (or little) production, and/or no (or little) physical presence in the Member State of registration.

⁴ Directive 96/71/EC concerning the posting of workers in the framework of the provision of services as amended by Directive 2018/957.

2. Indicators of the use of shell companies in the EU

2.1. Availability of data on shell companies

The number of shell companies in the European Union and the corresponding impact of shell companies on the EU economy cannot be determined from the data available.

With regard to the first two 'types' of shell company – anonymous shell companies and letterbox companies – a close look at a company should be sufficient to determine whether it is indeed a shell company or not. Is it a 'real' company or a company that exists merely on paper? Does it carry on any substantive economic activity in the Member State of registration / incorporation / or anywhere? Does it have employees? Is there a high financial flow through the company? Is this financial flow commensurate with the company's economic activity and/or number of employees? This level of detail in data is generally not present in the various publicly available databases that provide information on EU companies. Earlier researchers⁵ have noted difficulties in finding reliable aggregate company-level data. We report on their findings in Section 2.3. below.

With regard to the third type of shell company – the SPE – detailed information on foreign direct investment (FDI) is publicly available, while the information on FDI carried out through SPEs has recently become available. However, it is not always available for all Member States. This is reported in some detail in Section 2.4.

2.2. Research approach

A review of the literature,⁶ including the outcomes of the work of the [TAXE](#), [TAX2](#) and [PANA](#) committees⁷ seem to indicate that a high number of shell companies in a country correlates with several other characteristics, such as the high number of foreign-owned companies per inhabitant; foreign-owned companies being much more profitable than their local counterparts; an unusually high ratio of foreign direct investment against a country's GDP; a zero or low nominal or effective company tax rate, and zero or low withholding tax rates (dividends, interests, royalties).

Given the general lack of data, especially in the case of the first two types of shell company, this study takes an indirect approach that looks for proxies as **possible indicators** of the presence and magnitude of shell companies in the EU, based mostly on macroeconomic indicators. These indicators are:

- the number of foreign-owned companies in Member States (Section 2.3.);
- each Member State's ratio of FDI to GDP, with a particular focus on FDI held through SPEs (Section 2.4.);
- the profitability gap between foreign and domestic companies in Member States (Section 2.5).

⁵ See for instance: London School of Economics (LSE), [Study on the Law Applicable to Companies](#), prepared for the European Commission, 2016, especially pp. 33-44.

⁶ Academic literature, think tank publications, published books and articles in mainstream and specialised media.

⁷ See for instance point 75 of the TAXE resolution ([2015/2066\(INI\)](#)), which states inter alia that some countries present 'disproportionate economic fundamentals as compared with their size and real economic activity, especially when looking at, for instance, the number of resident companies per inhabitant, the amount of foreign profits booked, FDI or outgoing financial flows as compared to GDP, etc.'.

None of these proxy indicators can be understood as definitive evidence of the existence or numbers or impact of shell companies in the EU. Nevertheless, taken together, and combined with other sources (information resulting from public scrutiny, academia, think tanks, investigative journalism, company audits, etc.), these indicators can contribute to a better understanding of the phenomenon of shell companies in the European Union.

2.3. Share of foreign-owned companies in Member States

The **first proxy indicator** for the existence of shell companies in the EU is the **number of foreign-owned companies in the Member States**. It is important to note that, although shell companies are generally foreign-owned companies, needless to say that not all foreign-owned companies are shell companies.

Nonetheless, the share of foreign-controlled companies in a country has been used as one indicator of aggressive tax planning in general,⁸ not least when an unusually high number of foreign-controlled companies cannot be explained by other factors.

Determining the number of foreign-controlled companies is in itself not an easy task however. As mentioned in a London School of Economics (LSE) study: 'Collecting this data proved extremely challenging, as the information that the national registries keep is partial, and the commercial databases were inconsistent and scarce'.⁹ Along these lines, the review of relevant literature does not appear to lead to conclusive findings.

The estimates presented below rely primarily on the 2016 study for the European Commission on the Law Applicable to Companies (LSE, 2016).¹⁰

The study provides an overview of **difficulties encountered in the task of collecting data on the number of companies** that operate in a Member State other than the one in which they have been incorporated or have their real seat. It also provides an overview of earlier research on the topic and the different 'proxies' used in previous research in an effort to identify the 'nationality of a company'.¹¹ The LSE study estimates the numbers of foreign companies defined as 'companies with all managers being from one of the other member states and the majority of those managers being shareholders'.

Using this interpretation, the study estimates that there are approximately 420 000 incorporations of foreign businesses in the commercial registers of the EU Member States, with the UK accounting for more than half (227 000). The remaining foreign companies are divided between Estonia (33 500), Romania (30 000), France (27 000), Slovakia (26 600) and the remaining 23 Member States (75 000),¹² as presented in **Figure 1** below. The study does not provide estimates for all the Member

⁸ See for instance: Institute for Advanced Studies (IHS), [Aggressive tax planning indicators](#), prepared for the European Commission, DG TAXUD Taxation papers, Working paper No 71, October 2017, see the summary of country-level indicators of aggressive tax planning, Table 31, p. 114. This is the last of the three studies on aggressive tax planning launched by the European Commission DG TAXUD. The other two are: Study on Structures of Aggressive Tax Planning and Indicators, Working paper No 61, and The Impact of Tax Planning on Forward-Looking Effective Tax Rates, Working paper No 64, both available on the [DG TAXUD Taxation papers webpage](#).

⁹ London School of Economics (LSE), [Study on the Law Applicable to Companies](#), prepared for the European Commission, 2016, p. 33.

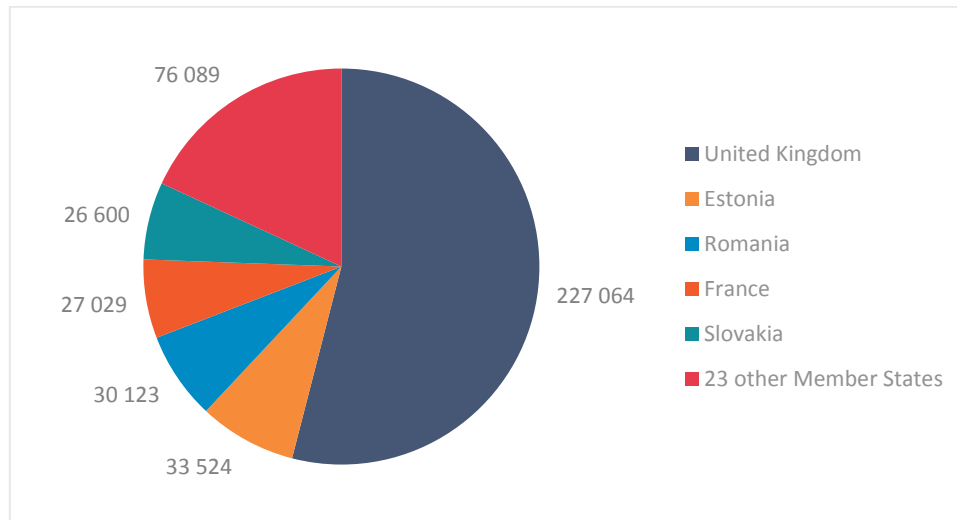
¹⁰ LSE, [Study on the Law Applicable to Companies](#), prepared for the European Commission, 2016. The data quoted in this paper is 2015 data, while the other parts of the study look into wider period (e.g. time series of incorporations from two Member States, which has a time frame of 1990 to 2015).

¹¹ LSE, [Study on the Law Applicable to Companies](#), prepared for the European Commission, 2016, pp. 33-38.

¹² LSE, [Study on the Law Applicable to Companies](#), prepared for the European Commission, 2016, p. 43.

States, but only for the five Member States mentioned above and for the EU as a whole. The remaining number of some 75 000 companies thus presumably represents an aggregate for the remaining 23 Member States.

Figure 1 – Estimated number of foreign companies



Source: 2016 LSE Study on the Law Applicable to Companies, Table 3, p. 43: Top target countries of businesses incorporated in other Member States, estimates of LSE authors, based on data from Bureau van Dijk Orbis.

The findings indicate that the UK is by far the most popular target country, followed by three central and eastern European Member States and France. The research provides possible explanations for the popularity of some central and eastern European Member States: these include matters relating to company law and also to favourable tax and labour laws.

The above findings have been widely quoted, especially the estimate of some 500 000 foreign companies.¹³ Again it should be emphasised in this context that the estimate of 420 000 indicates 'business incorporated in other Member States' and not the number of shell companies as such.

Finally, in this context, it is worth noting that, at the time of writing, a pilot project on letterbox companies is ongoing in the European Commission, with the study expected in the second quarter of 2019.¹⁴ This study is expected to provide further details on the phenomenon of shell companies in the EU.

2.4. Foreign direct investment (FDI) as a share of GDP

The **second proxy measurement** is the ratio of **foreign direct investment (FDI)** in an EU Member State to the GDP of that Member State.

Foreign direct investment is a '**cross-border investment made by a resident in one economy** (the direct investor) with the objective of establishing a lasting interest **in an enterprise** (the direct investment enterprise) **that is resident in an economy other than that of the direct investor**. The

¹³ Note that LSE researchers came to the final estimate of 420 000 incorporations of foreign businesses after deducting from the original estimate of around 500 000 companies those companies of foreigners who are resident in the Member State of the incorporation.

¹⁴ [Pilot project – Letterbox companies](#), a study aimed at gathering comprehensive information about the purposes of letterbox companies relevant for company law, heading 33 03 77 05.

motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise. The "lasting interest" is evidenced when the direct investor owns at least 10 % of the voting power of the direct investment enterprise. Direct investment may also allow the direct investor to gain access to the economy of the direct investment enterprise which it might otherwise be unable to do.¹⁵

FDI is regarded as economically useful as it can lead to real economy activity. FDI – 'whether mergers and acquisitions or "greenfield"¹⁶ ventures built from the ground up – is generally thought of as reflecting brick and mortar decisions, i.e., decisions based on long-run factors. Conventional wisdom on capital flows holds that FDI inflows are "good" flows [...].'¹⁷

FDI 'provides a means for creating direct, stable and long-lasting links between economies. Under the right policy environment, it can serve as an important vehicle for local enterprise development, and it may also help improve the competitive position of both the recipient ("host") and the investing ("home") economy.'¹⁸

Data on foreign direct investment in Member States

The figures below present the **total inward and outward FDI stocks for each EU Member State**, both in terms of the value of investments (expressed in millions of dollars)¹⁹ and as percentage of Member States' GDP. The figures given are based primarily on the European Commission data, in particular on the 2017 IHS Report on Aggressive Tax Planning Indicators²⁰ and on the 2018 European Semester Country Reports.²¹

Inward foreign direct investment (inward FDI) refers to investment by foreigners in business resident in a given Member State.

Outward foreign direct investment (outward FDI) refers to investment by resident entities in affiliated business abroad.

As the below figures show, several Member States have particularly high inward FDI in absolute values (**Figure 2**) and/or when FDI is presented as a percentage of Member State GDP, to account for country-size effects (**Figures 3 and 4**).

¹⁵ OECD, [Benchmark Definition of Foreign Direct Investment](#), Fourth edition, 2008, p. 17, emphasis added.

¹⁶ A company may enter a foreign market through what is referred to as greenfield direct investment, in which the direct investor provides funds to build a new factory, distribution facility, or store, for example, to establish its presence in the host country, from IMF, Finance and Development, [What is Direct Investment?](#), September 2015.

¹⁷ O. Blanchard and J. Acalin, [What Does Measured FDI Actually Measure?](#), Policy Brief 16-17, Peterson Institute for International Economics, October 2016, p.1.

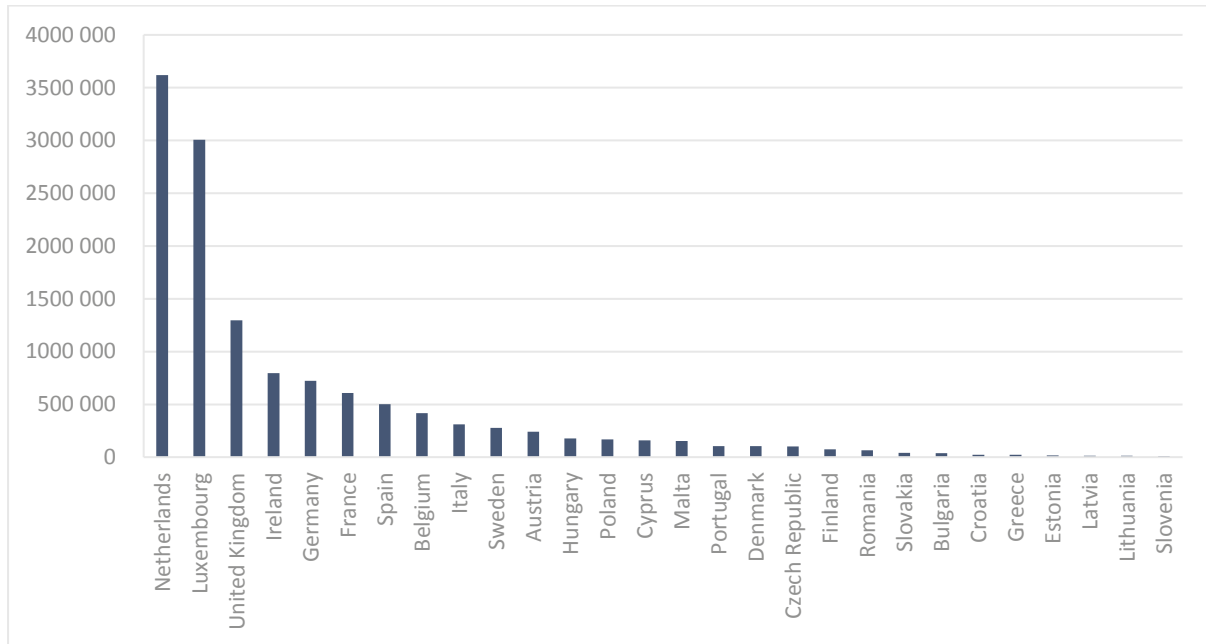
¹⁸ OECD, [Benchmark Definition of Foreign Direct Investment](#), Fourth edition, 2008, p. 14.

¹⁹ FDI stocks are measured in US dollars and as a share of GDP. 2017 IHS study uses USD in the tables that serve as the basis for our figures. US dollar values are thus retained here, rather than euro values.

²⁰ IHS, [Aggressive tax planning indicators](#), prepared for the European Commission, DG TAXUD Taxation papers, Working paper No 71, October 2017.

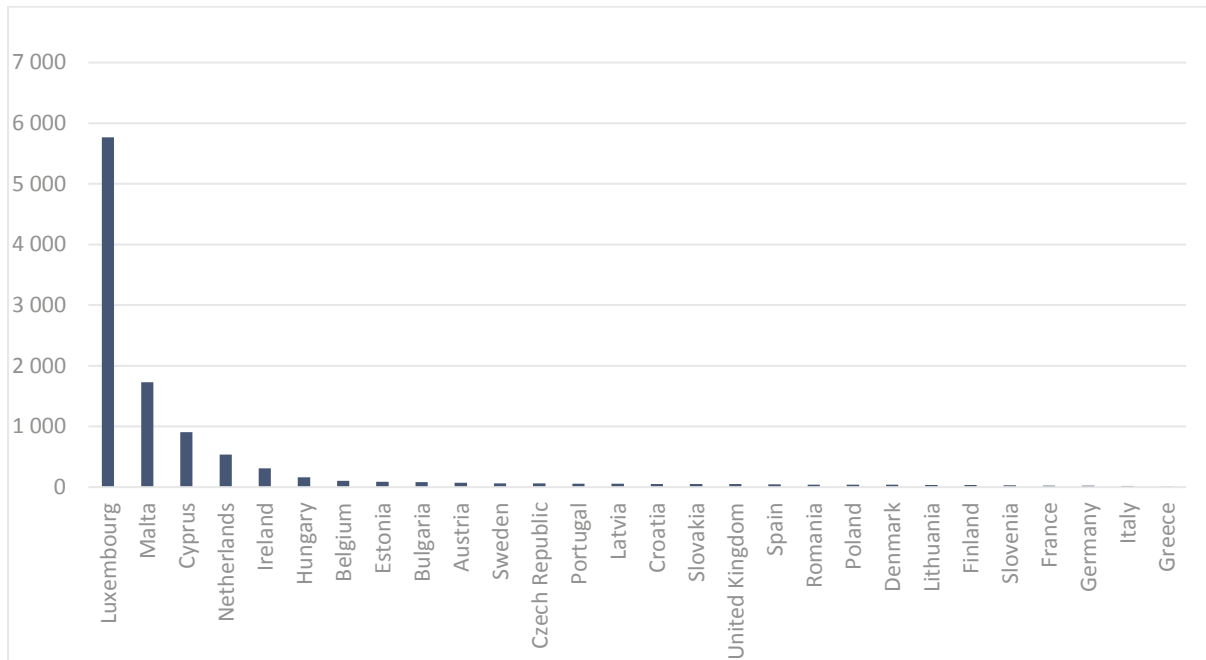
²¹ European Commission, 2018 European Semester assessment, general document [COM\(2018\)120](#) and Country Reports SWD(2018)200-226, 7 March 2018.

Figure 2 – Inward FDI stock in US\$ million (2015)



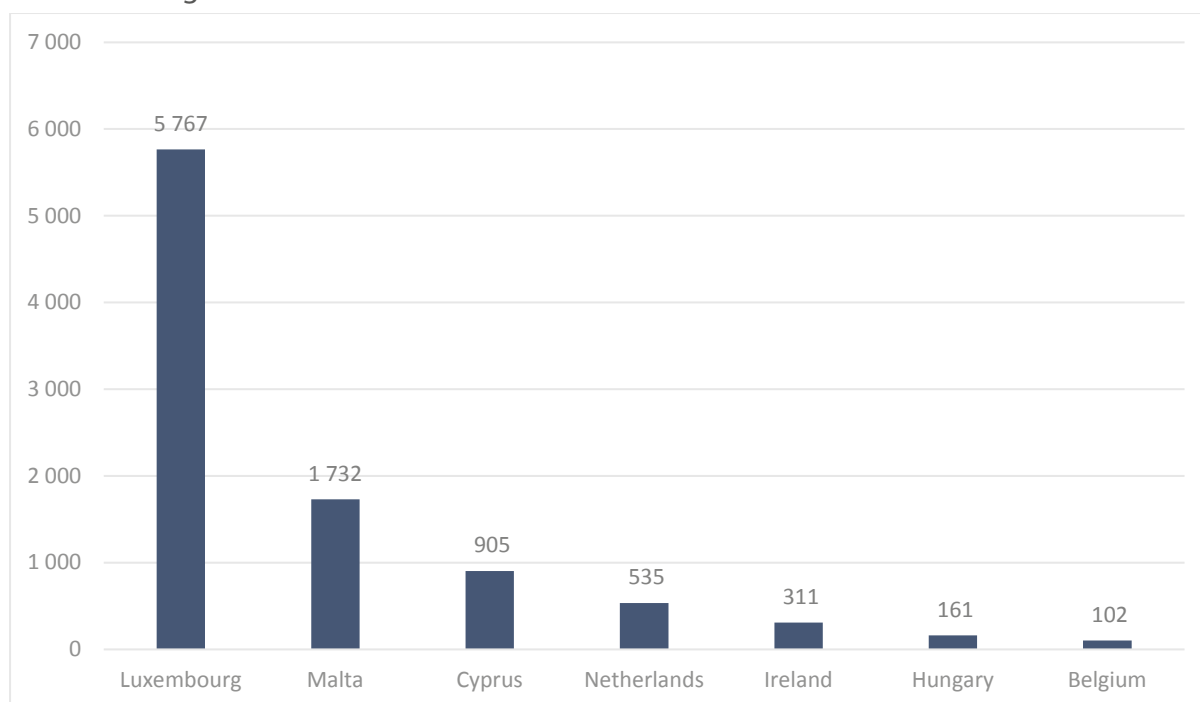
Source: 2017 IHS Report on Aggressive tax planning indicators.

Figure 3 – Inward FDI stock as a percentage of GDP (2015)



Source: 2017 IHS Report on Aggressive tax planning indicators

Figure 4 – Inward FDI stock as a percentage of GDP (2015) for Member States with inward FDI exceeding GDP

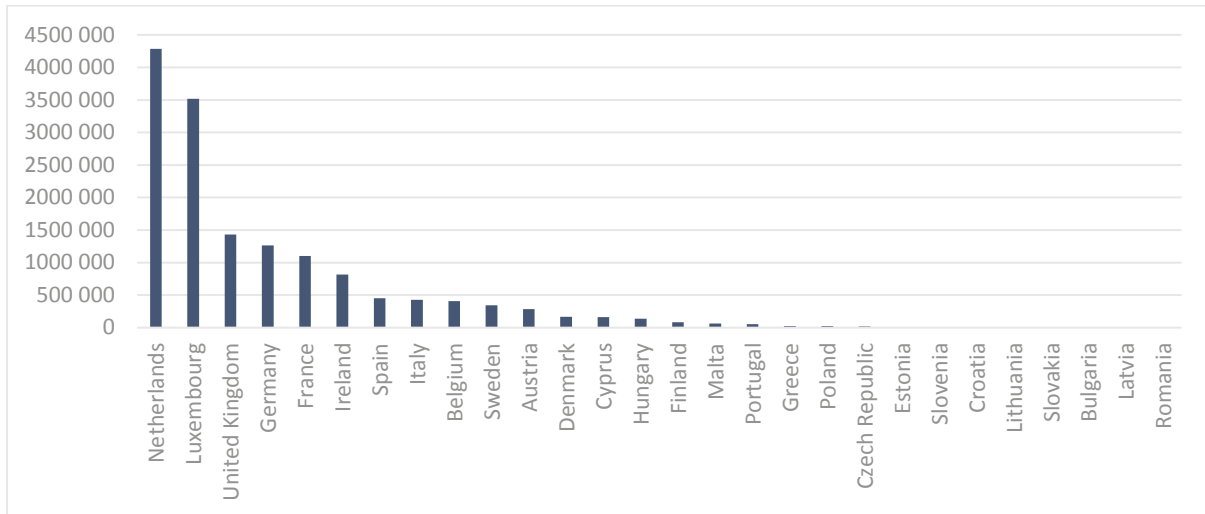


Source: 2017 IHS Report on Aggressive tax planning indicators.

In Luxembourg, inward FDI amounts to more than 57 times GDP (FDI stocks represent 5 766 % of Luxembourg's GDP). The percentages for countries that follow in the figure above might appear smaller in comparison, but are still multiples of those Member States' GDP: in Malta, inward FDI amounts to more than 17 times its GDP; in Cyprus to 9 times its GDP; in the Netherlands, to more than 5 times its GDP; in Ireland, more than 3 times of its GDP, etc.

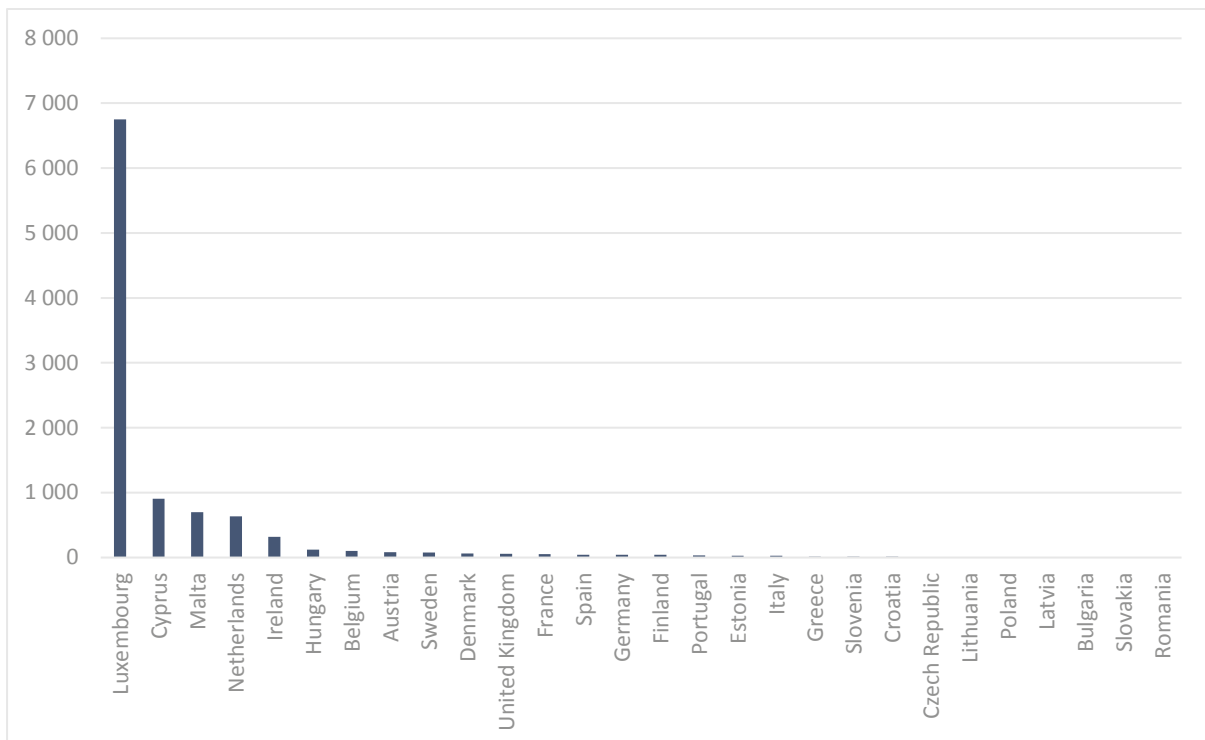
Looking at **outward FDI stocks**, i.e. what resident entities in EU Member States invest in business abroad, similarities can be seen. Again, several Member States stand out with particularly high outward FDI stocks in absolute values (**Figure 5**) and as percentage of GDP (**Figures 6 and 7**).

Figure 5 – Outward FDI stock in US\$ million (2015)



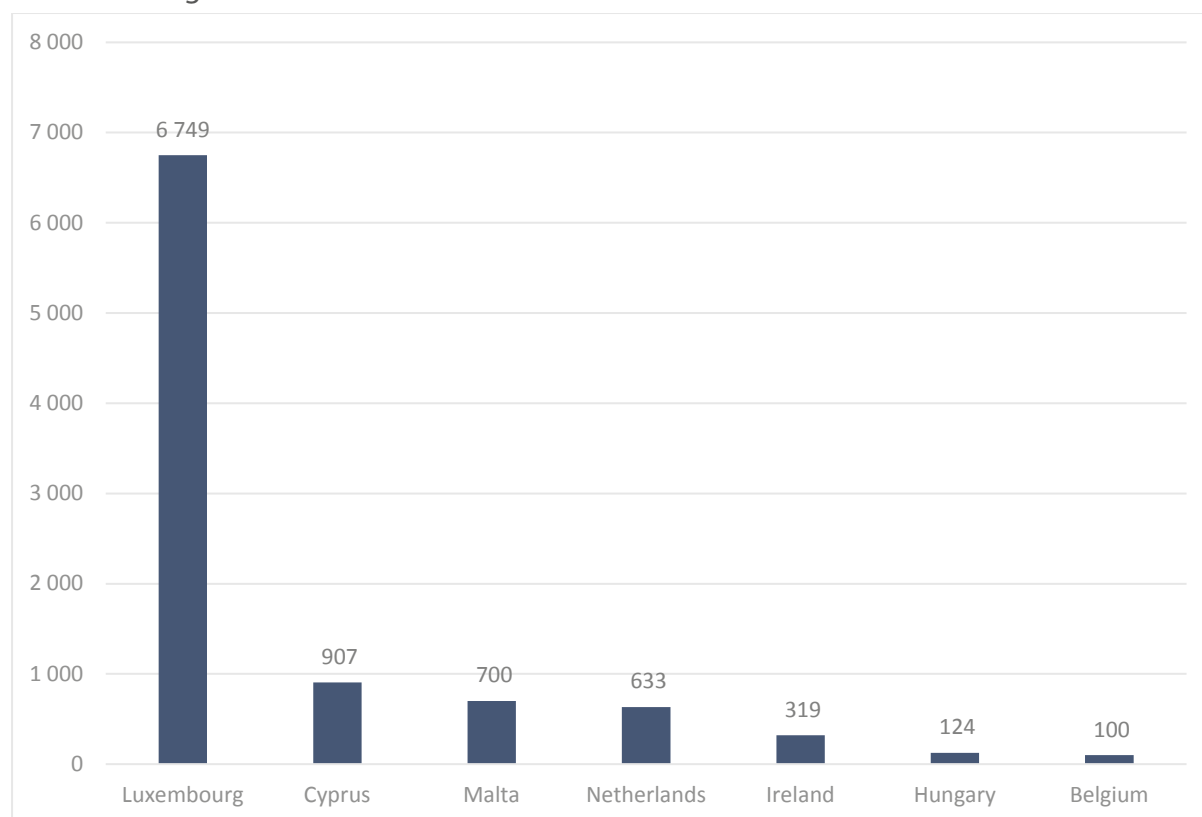
Source: 2017 IHS Report on Aggressive tax planning indicators.

Figure 6 – Outward FDI stock as a percentage of GDP (2015)



Source: 2017 IHS Report on Aggressive tax planning indicators.

Figure 7 – Outward FDI stock as a percentage of GDP (2015) for Member States with outward FDI exceeding GDP

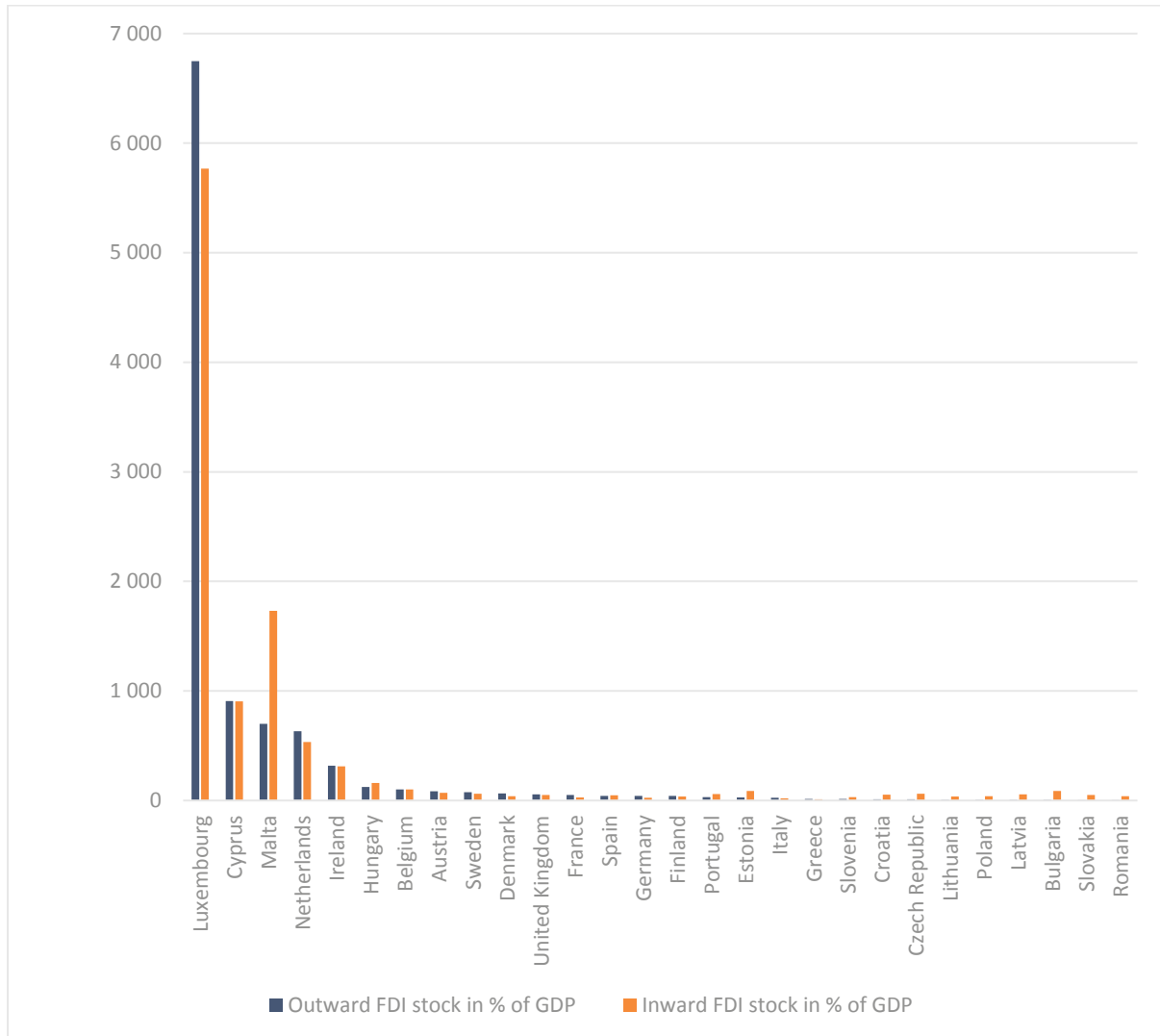


Source: 2017 IHS Report on Aggressive tax planning indicators.

Several Member States have particularly high outward FDI in absolute values (Figure 5) and/or when FDI is presented as a percentage of a Member State's GDP, to account for country-size effects (**Figures 6 and 7**).

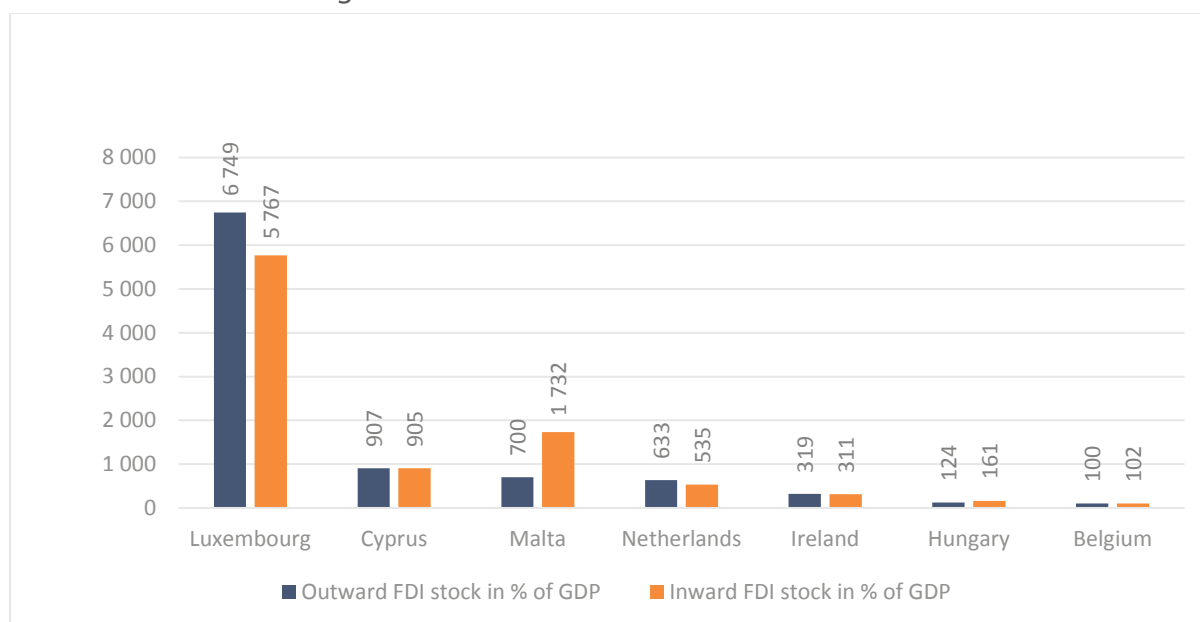
Finally, **Figure 8** below presents **combined inward and outward FDI positions as a share of GDP**, while **Figure 9** presents the same for those Member States standing out significantly from the EU 28's inward FDI of 63.1 % and outward FDI of 72.9 %.

Figure 8 – Foreign direct investment positions as a percentage of GDP (2015)



Source: 2017 IHS Report on Aggressive tax planning indicators.

Figure 9 – Foreign direct investment positions as a percentage of GDP (2015) for Member States with FDI exceeding GDP



Source: 2017 IHS Report on Aggressive tax planning indicators.

‘Several Member States stand out with particularly high values of both inward and outward FDI stocks. In Luxembourg both inward (5 766 %) and outward (6 749 %) FDI stocks are a multiple of the GDP. Similarly, in Malta, inward FDI amount to more than 17 times of the GDP and the FDI outward stocks are also 7 times larger than the GDP. For Cyprus (around 900 percent of GDP), the Netherlands (more than 500 percent of GDP) and Ireland (more than 3 times GDP), we can also observe extraordinarily large inward and outward FDI stocks. Very large parts of this FDI stocks appear to be held in SPEs [...]. The very high level of both inward and outward FDI stocks are [taken as] a clear indication of the attractiveness of Cyprus, Luxembourg, Malta and the Netherlands for holding companies, which themselves are foreign owned.’²²

Importance of special purpose entities (SPEs) in foreign direct investment

The question to ask at this point relates to discrepancies in the figures presented above: ‘since FDI is often considered to be a proxy for “brick and mortar” [genuine long-term] investments, how can ... small economies play such a significant role?’²³ Do these extraordinarily high inward FDI stocks really represent genuine long-term investment in these Member States or are there other factors at play that could explain them?

Statistical data on FDI and research done based on these data provide an answer: it appears that big portions of FDI are held by **special purpose entities (SPEs)** and that this SPE-held portion of FDI does not seem to represent a genuine investment in a particular country but rather financial flows through that country.²⁴

²² IHS, [Aggressive tax planning indicators](#), prepared for the European Commission, DG TAXUD Taxation papers, Working paper No 71, October 2017, pp. 68-69.

²³ J. Damgaard and T. Elkjaer, [The Global FDI Network: Searching for Ultimate Investors](#), IMF Working Paper 17/258, November 2017, p.4.

²⁴ On this, see e.g. J. Damgaard and T. Elkjaer, [The Global FDI Network: Searching for Ultimate Investors](#), IMF Working Paper 17/258, November 2017; P. Lane and G.-M. Milesi-Ferretti, [International Financial Integration in the aftermath](#)

Special purpose entities (SPEs)

In general terms, special purpose entities are entities with no or few employees, little or no physical presence in the host economy, whose assets and liabilities represent investments in or from other countries, and whose core business consists of group financing or holding activities.²⁵

Although there is **no universal definition of SPEs**, they do share a number of features. **An enterprise is usually considered to be a special purpose entity (SPE) if it meets the following criteria:**

- 1) The enterprise is a **legal entity**, formally registered with a national authority, and subject to fiscal and other legal obligations of the economy in which it is resident.
- 2) The enterprise is **ultimately controlled by a non-resident parent**, directly or indirectly.
- 3) The enterprise has **no or few employees, little or no production** in the host economy and **little or no physical presence**.
- 4) Almost all the **assets and liabilities** of the enterprise **represent investments in or from other countries**.
- 5) The core business of the enterprise consists of group **financing or holding activities**, that is ... the **channelling of funds from non-residents to other non-residents**. However, in its daily activities, managing and directing plays only a minor role.²⁶

The SPE-held share of FDI will not generally bring about job creation, production, and construction of factories and transfer of technology. As explained by the OECD, '**when a country hosts SPEs and includes them in its FDI statistics, an increasing part of transactions and positions merely reflects the channelling of funds via this country**'. This can lead to a more and more significant overstatement of FDI activity.

FDI transactions passing through an SPE **generally do not have the expected immediate impact of direct investment** concerning matters such as technology transfers, access to competitive markets, and poverty reduction in the SPE host countries.²⁷

Simply put, 'Measured FDI is not entirely true FDI'.²⁸ Rather, measured **FDI can be broadly divided in two distinct groups**: the 'genuine' investment in the host economy, and the SPE-held part of the investment, which is not a 'genuine' investment in the host economy but rather channelling of funds via this economy.

[of the global financial crisis](#), IMF Working Paper 17/115, May 2017; and O. Blanchard and J. Acalin, [What Does Measured FDI Actually Measure?](#), Policy Brief 16-17, Peterson Institute for International Economics, October 2016.

²⁵ OECD, [Addressing Base Erosion and Profit Shifting](#), 2013, p.18.

²⁶ OECD, [Benchmark Definition of Foreign Direct Investment](#), Fourth edition, 2008, p. 102, Box 6.2, emphasis added.

²⁷ OECD, [Benchmark Definition of Foreign Direct Investment](#), Fourth edition, 2008, p. 102, emphasis added.

²⁸ O. Blanchard and J. Acalin, [What Does Measured FDI Actually Measure?](#), Policy Brief 16-17, Peterson Institute for International Economics, October 2016, p.4.

A closer look at Member States' foreign direct investment through special purpose entities

A closer look at the EU Member States is provided by the European Commission's **European Semester March 2018 country reports**, which point to:

- **high inward and outward FDI stocks noted in seven Member States** that 'can only be partially explained by real economic activities taking place',²⁹ and

- **a high share of FDI stock held by SPEs in several Member States**: Malta (96 % inward and 98 % outward FDI in SPEs), Luxembourg (around 95 % of FDI in SPEs) and the Netherlands (80 % inward and 73 % outward of FDI in SPEs).³⁰

What are the reasons for this channelling of funds via SPEs? There are many reasons for multinational enterprises (MNEs) using SPEs. These include the management of large and complex operations, enabling the internal financing of MNEs, and **tax considerations** appear to play the most important role. On this, an IMF paper notes that 'Aggregate international investment positions and behaviour are **strongly marked by tax considerations**. [...] jurisdictions known for **attractive tax regimes** and **extensive treaty networks** commonly feature prominently as 'conduits' through which investments pass.'³¹ The OECD notes that, as legal devices SPEs may be relatively cheap to create and to maintain, they may offer '**taxation, regulatory, and confidentiality benefits**'.³²

Unusually **high foreign direct investment** as well as a **high proportion of FDI held by SPEs** are included among the economic **indicators** that may be used to detect evidence of **aggressive tax planning** (ATP) practices.³³

As stated by Commissioner for Economic and Financial Affairs Pierre Moscovici when presenting the European Semester reports in March 2018, 'these practices [...] have the potential to **undermine fairness** and the **level playing field in our internal market**, and they **increase the burden on EU taxpayers**'.³⁴ In the same speech, the Commissioner stressed the issue of aggressive tax planning in seven EU countries: Belgium, Cyprus, Hungary, Ireland, Luxembourg, Malta and the Netherlands.

Finally, when it comes to the **sustainability of the foreign direct investment** in the EU, foreign direct investment through SPEs is **less stable in comparison with other types of FDI** 'because even small legislative changes – domestically or abroad – can significantly shift investment patterns and lead to capital outflows'.³⁵ For example, a recent IMF report on Luxembourg, while generally positive, notes that 'The large increase in FDI by special purpose vehicles in Luxembourg in recent years suggests that incentives to locate multinational assets in the country have been very strong. Greater corporate tax transparency, the US tax reform and further anti-tax-avoidance measures

²⁹ These are the same Member States as in Figure 9 above.

³⁰ See also J. Damgaard and T. Elkjaer, [The Global FDI Network: Searching for Ultimate Investors](#), IMF Working Paper 17/258, November 2017, Annex I on p. 23, which gives inward FDI positions broken down into SPEs and non-SPEs for 21 EU Member States and several other countries.

³¹ IMF, [Spillovers in International Corporate Taxation](#), IMF Policy Paper, 9 May 2014, p. 15, emphasis in bold added.

³² OECD, [Benchmark Definition of Foreign Direct Investment](#), Fourth edition, 2008, p. 101, emphasis in bold added.

³³ European Commission, European Semester Thematic Factsheet - [Curbing Aggressive Tax Planning](#), November 2017.

³⁴ [Opening remarks](#) by Commissioner Moscovici on the European Semester Winter Package, 7 March 2018.

³⁵ J. Damgaard and T. Elkjaer, [The Global FDI Network: Searching for Ultimate Investors](#), IMF Working Paper 17/258, November 2017, p. 9.

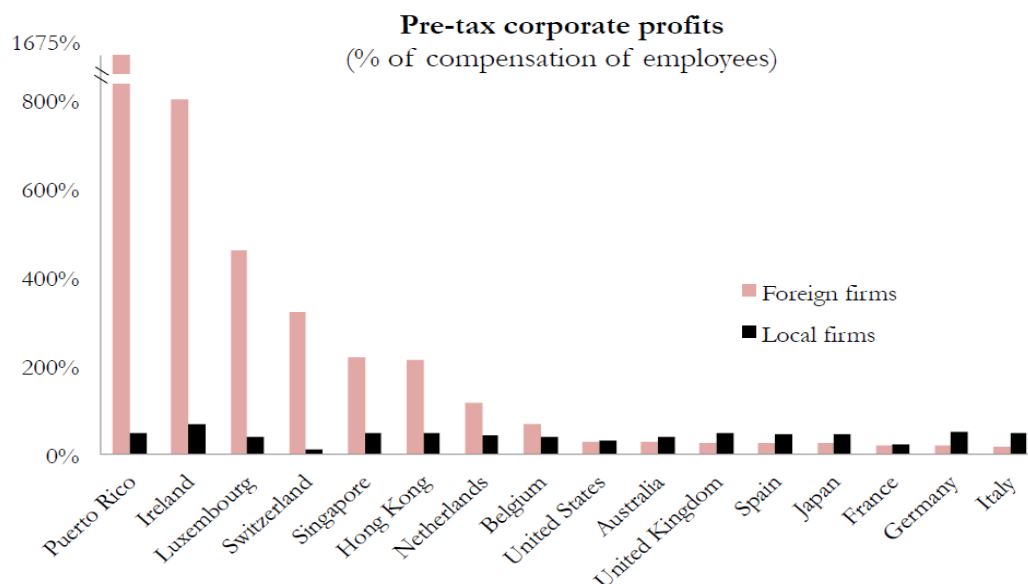
could, however, diminish incentives to conduct business through Luxembourg and affect corporate taxes and economic activity.¹³⁶

2.5. Profitability gap between foreign and domestic companies in Member States

The **third proxy indicator** is the **profitability gap between foreign and domestic companies** in a Member State. As shown in Figures 10 and 11 below, Tørsløv, Wier and Zucman's research in 2018³⁷ shows that some countries have systematically higher profitability in the foreign-controlled sector than in the local sector.

Figure 10 below presents pre-tax corporate profits as a percentage of compensation of employees, with **Figure 11** including the same data for EU Member States only.³⁸

Figure 10 – Pre-tax corporate profits (% of compensation of employees)



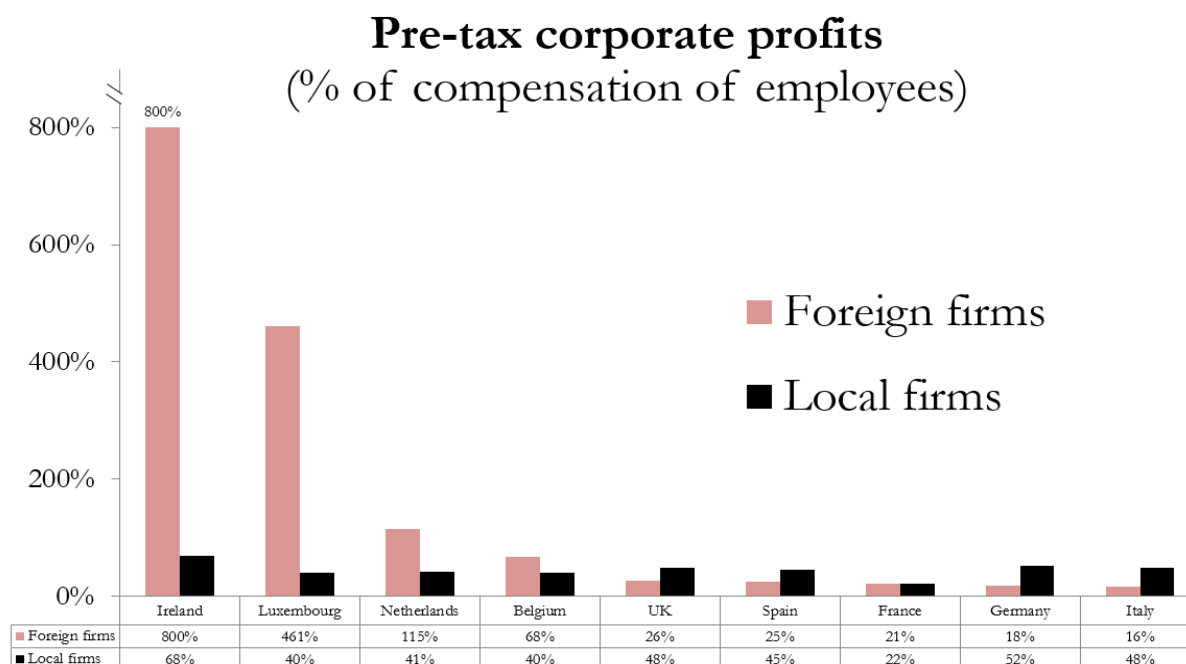
Source: Tørsløv, Wier and Zucman, 2018.

³⁶ [IMF Staff Country Reports](#) – Luxembourg, April 2018, p. 17.

³⁷ T. Tørsløv, L. Wier and G. Zucman, [The Missing Profits of Nations](#), Working paper, July 2018.

³⁸ Note that not all EU Member States were included in this research.

Figure 11 – Pre-tax corporate profits (% of compensation of employees)



Source: Tørsløv, Wier and Zucman, 2018.

Tørsløv, Wier and Zucman explain this profitability gap through a combination of multinationals booking intangible assets (patents, logos, algorithms, etc.) in low-tax affiliates and intra-group transfer prices. They find 'a clear trace in global macro data of **movements of profits** within divisions of multinational groups, **away from high-tax affiliates and towards low-tax affiliates**.'³⁹

2.6. Interpretation of the three indicators

Having examined three proxy indicators, it should be noted that none of the indicators taken alone can be understood as definitive evidence of the existence or numbers or impact of shell companies in the EU.

However, taken together, and interpreted in conjunction with other sources of information (information resulting from public scrutiny, academia, think tanks, investigative journalism, company audits, etc.), the three indicators do point to the existence of shell companies within the EU, on a magnitude that seems to differ in each EU Member State.

These shell companies could pose risks to the EU, as presented in the following section of this paper.

³⁹ T. Tørsløv, L. Wier and G. Zucman, [The Missing Profits of Nations](#), Working paper, July 2018, p. 19.

3. Risk assessment of the use of shell companies in the EU

The use of shell companies can be legal and have legitimate purposes. For example, they can be used to hold personal or family assets to facilitate inheritance.⁴⁰ When buying property or land, well-known brands often hide their identity behind shell companies so that they can be protected from high price increases by the owner.⁴¹ Shell companies can serve legitimate business purposes and are sometimes needed to facilitate corporate mergers, joint ventures and estate planning.⁴²

While they can have a number of legitimate usages, **shell companies can also be used as a vehicle for tax avoidance, tax evasion, and money laundering.**⁴³ Shell companies do not necessarily carry risks because of what they are, but used in combination with other instruments such as international tax agreements or poor transparency requirements, they can increase and facilitate the concealment of the origin of assets, the hiding of beneficial owners or fraud workers' rights. All of these elements, together or apart, bear serious risks of money laundering, tax evasion, tax avoidance and abuse of labour and social laws (see Section 3.1). These illegal uses bear risks to the economy and the society as a whole, having economic, political and social impacts (see Section 3.2). In recent years however, the EU, often based on OECD recommendations, has taken some measures to mitigate these risks (see Section 3.3).

3.1. Identified risks

Shell companies do not represent threats because of what they are, but used in combination with other instruments, such as international tax treaties or low transparency requirements, they may involve risks. According to the relevant literature, the main risk is the secrecy surrounding shell companies, which allows them to be a vehicle for tax avoidance, tax evasion and money laundering. The possibility to set up and use shell companies to access the preferential treatment offered by international tax treaties or international investment treaties is also a risk. Finally, shell companies in the EU are sometimes set up to circumvent the obligations of the posting of workers directive.

3.1.1. Risks associated with anonymity

Anonymity is a key element that makes the use of shell companies attractive. An important function that a shell company can offer to its owner is to provide anonymity while simultaneously guaranteeing control over the shell company and its resources.⁴⁴ These anonymous shell companies are corporate entities that have disguised their ownership in order to operate without scrutiny from law enforcement or the public. They are used to conceal the identity of their true owner – the person who ultimately controls or profits from the company. These people are also known as the 'beneficial owners'.

⁴⁰ E. van der Does de Willebois, Emily M. Halter, Robert A. Harrison, J. Won Park and J.C. Sharman, 'The Puppet Masters – How the corrupt use legal structures to hide stolen assets and what to do about it', International Bank for Reconstruction and Development / World Bank, 2011.

⁴¹ Michael G. Findley, Daniel L. Nielson and J. C. Sharman, *Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism*, 2014, p.33.

⁴² M. Aydogdu, C. Shekhar and V. Torbey, 'Shell companies as IPO alternatives: an analysis of trading activity around reverse mergers', *Applied Financial Economics*, 17:16, pp. 1335-1347.

⁴³ [The misuse of corporate vehicles, including trust and company service providers](#), FAFT GAFI, 2006.

⁴⁴ FATF - Edmont group, [Concealment of Beneficial Ownership](#), FATF, 2018.

The **4th Anti-Money-Laundering Directive (AMLD)**⁴⁵ defines the 'beneficial owner' as 'any natural person(s) who ultimately owns or controls the customer and/or the natural person(s) on whose behalf a transaction or activity is being conducted and includes at least:

(a) in the case of corporate entities:

(i) the natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership of a sufficient percentage of the shares or voting rights or ownership interest in that entity, including through bearer shareholdings, or through control via other means, other than a company listed on a regulated market that is subject to disclosure requirements consistent with Union law or subject to equivalent international standards which ensure adequate transparency of ownership information.

A shareholding of 25 % plus one share or an ownership interest of more than 25 % in the customer held by a natural person shall be an indication of direct ownership. A shareholding of 25 % plus one share or an ownership interest of more than 25 % in the customer held by a corporate entity, which is under the control of a natural person(s), or by multiple corporate entities, which are under the control of the same natural person(s), shall be an indication of indirect ownership. This applies without prejudice to the right of member states to decide that a lower percentage may be an indication of ownership or control. Control through other means may be determined, inter alia, in accordance with the criteria in Article 22(1) to (5) of Directive 2013/34/EU of the European Parliament and of the Council (29);

(ii) if, after having exhausted all possible means and provided there are no grounds for suspicion, no person under point (i) is identified, or if there is any doubt that the person(s) identified are the beneficial owner(s), the natural person(s) who hold the position of senior managing official(s), the obliged entities shall keep records of the actions taken in order to identify the beneficial ownership under point (i) and this point; [...].'

Shell companies are a threat when they cannot be traced back to the beneficial owner. These anonymous shell companies can then become a tool for money launderers to hide their business and assets from the authorities. They are used by criminals because they screen or veil illicit conduct.⁴⁶

The potential for anonymity is a critical factor in facilitating the misuse of shell companies.⁴⁷ It increases the possibility of them being used for various types of crime, including money laundering,⁴⁸ bribery and corruption, hiding assets from creditors, different types of illegal fiscal

⁴⁵ [Directive \(EU\) 2015/849](#) of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC (Text with EEA relevance), in its Article 3(6).

⁴⁶ There are many instances of shell companies being used in criminal schemes, see: Michael G. Findley, Daniel L. Nielson and J. C. Sharman, *Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies*, 2012.

'The Iranian government used shell companies from Germany, Malta, and Cyprus to evade international sanctions by concealing the ownership of its oil tankers. [...] The British arms firm BAE Systems pleaded guilty in 2010 in connection with case which saw it pass secret funds through a series of middle-men and shell companies incorporated in Britain and the British Virgin Islands to key Saudi officials responsible for approving a massive arms purchase from BAE. [...] Corrupt Russian tax officials used shell companies from Cyprus and the British Virgin Islands to steal hundreds of millions of dollars in a case that led to the imprisonment and death of Russian whistle-blower Sergei Magnitsky.'

⁴⁷ [The Misuse of Corporate Vehicles, Including Trust and Company Service Providers](#), FATF, 2006.

⁴⁸ Financial Crimes Enforcement Network, [Potential Money Laundering Risks Related to Shell Companies](#), 2006.

practices, and self-dealing.⁴⁹ They can be used to hide illegal businesses or to facilitate illegal activity, such as tax evasion or concealing the true ownership of real estate.

In order to test how easy it was to establish anonymous shell companies, a 2010 study by Sharman audited the possibility of setting up anonymous shell companies without proof of identity, and then establishing corporate bank accounts for these companies.⁵⁰ For that Sharman solicited offers of anonymous shell companies from 54 different corporate service providers in 22 different countries. The transactions that could have processed through such shell companies would have become effectively untraceable, thus very useful for those looking to hide criminal profits, pay or receive bribes, finance terrorists, or escape tax obligations. The results indicated that small island offshore centres may have standards for corporate transparency and disclosure that are higher than major OECD economies. However, this study was conducted before the setting up of most of the EU measures mitigating the risks linked to anonymity of shell companies (see Section 3.1.1.). A similar study conducted after the full implementation of the new standards could serve as a case study for the ex-post evaluation of the measures mentioned in Section 3.3.

In summary, the **risks associated with anonymity** pertain primarily to the first category of shell company identified in this study – **anonymous shell companies**.

The next section presents the **risks associated with treaty abuse**. These risks are primarily associated with the third category of shell company identified in this paper – **special purpose entities**.

3.1.2. Risks associated with treaty abuse

In addition, shell companies are used to abuse international tax treaties and international investment treaties.

The lack of harmonisation of corporate and personal income taxes worldwide allows for treaty abuse. In the EU, Member States are free to decide on their tax systems provided they comply with EU rules.⁵¹ Each Member State sets its tax base and rate. They regulate independently which type of companies are tax resident in that state, and to which extent non-tax resident companies are subject to tax on income that they derive from that state. As a result the same income may be taxed in two or more states, giving rise to the problem of international double (or multiple) taxation. To limit multiple taxation of the same items of income, states enter into bilateral tax treaties to allocate between themselves their powers of taxation. International tax treaties should minimise the risk of double taxation by allocating taxing jurisdiction between the treaty partners. However, while they are used by some enterprises to eliminate double taxation, others also take advantage of them to avoid taxation, by establishing shell companies in countries with attractive treaties (treaty shopping),⁵² resulting sometimes in double (or multiple) non taxation.⁵³

⁴⁹ [The Misuse of Corporate Vehicles, Including Trust and Company Service Providers](#), FATF, 2006, and OECD: Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes, 2001.

⁵⁰ J.C. Sharman, 'Shopping for Anonymous Shell Companies: An Audit Study of Anonymity and Crime in the International Financial System', *Journal of Economic Perspectives*, 24 (4), 2010, pp. 127-40.

⁵¹ C. Remeur, [Tax policy in the EU - Issues and challenges](#), EPRS, European Parliament, 2015.

⁵² The [OECD glossary](#) defines treaty shopping as 'An analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty'. The term is normally applied to a situation where a person not resident of either of the treaty countries establishes an entity in one of the treaty countries in order to obtain treaty benefits'.

⁵³ See J. Rogers-Glabush, *International Tax Glossary*, 7th Edition, 2015; and A. Lejour, [The Foreign Investment Effects of Tax Treaties](#), Oxford University Centre for Business Taxation, 2014.

These strategies are implemented notably by establishing shell companies in states with desirable tax treaties. Typically, treaty abuse occurs where an enterprise interposes an entity, usually a shell company, in a third country to take advantage of the terms of a favourable provision in the country's treaty that would not be otherwise available to the enterprise if it structured itself through a more direct route between two countries. In short, treaty abuse allows a company to do indirectly what a particular treaty may not permit directly, with the aim of exploiting favourable tax rules in the country in which the shell company is situated.⁵⁴ Ultimately, this is done to reduce withholding taxes and characterise income to exempt otherwise taxable income, and can result in double non-taxation of income.

This use of shell companies to facilitate treaty shopping leads to tax avoidance – through aggressive tax planning,⁵⁵ profit shifting and transfer pricing⁵⁶ – and allows companies to benefit from the provisions of bilateral investment treaties, such as access to investor-state dispute settlement (ISDS) or investment court system (ICS).⁵⁷

3.1.3. Risks associated with the circumvention of the Posting of Workers Directive

Shell companies are also set up and used to facilitate undeclared work and avoid social security contributions. In the EU, the coordination of different national social security systems in cross-border situations is based on the so-called *lex loci laboris* principle, according to which persons moving within the EU are subject to the social security scheme of one EU Member State only, specifically that of the country in which the work is carried out. In accordance with this principle, workers from abroad have the right to be treated as if they were citizens of the host state.⁵⁸ An exception to the principle, however, is the so-called 'posting of workers', where workers temporarily stay in another Member State in order to provide services, but remain subordinate, as employees, to the posting company in their home country. Posted workers falling under the regime of the Posting of Workers Directive⁵⁹ (PWD) stay under the home-country social security regime rather than the host-country regime.⁶⁰

⁵⁴ K. E. Sørensen, '[The fight against letterbox companies in the internal market](#)', *Common Market Law Review*, 2015, pp. 85-118.

⁵⁵ For an easily understandable graphical illustration of the use of shell companies in this context, see '[Double Irish With a Dutch Sandwich](#)', *New York Times*, April 2012.

For an example (the Google case), see: Hadzhieva, [Tax Challenges in the Digital Economy](#), Policy Department for Economic and Scientific Policy, European Parliament, 2016, p.24.

⁵⁶ Robert Dover, Benjamin Ferrett, Daniel Gravino, Erik Jones and Silvia Merler, [Bringing transparency, coordination and convergence to corporate tax policies in the European Union - Assessment of the magnitude of aggressive corporate tax planning](#), EPRS, European Parliament, 2015.

⁵⁷ A new [report](#) by the Centre for Research on Multinational Corporations (SOMO) highlights the until now unexplored role that Dutch investment protection policies play in the establishment decisions of multinational corporations and investigates the risks associated with the far-reaching investment protections offered under Dutch bilateral investment treaties (BITs). The report finds that a majority of companies availing themselves of the generous investment protections offered by Dutch BITs are shell companies, with no employees on their payroll and no real economic activity in the Netherlands.

⁵⁸ S. Giubboni, F. Iudicone, M. Mancini and M. Faioli, [Coordination of Social Security Systems in Europe](#), Policy Department for Economic and Scientific Policy, European Parliament, 2017.

⁵⁹ [Directive 96/71/EC](#) of the European Parliament and of the Council of 16 December 1996 concerning the posting of workers in the framework of the provision of services and [Directive 2014/54/EU](#) of the European Parliament and of the Council of 16 April 2014 on measures facilitating the exercise of rights conferred on workers in the context of freedom of movement for workers.

⁶⁰ M. Kiss, [Posting of Workers Directive](#), EPRS, European Parliament, 2018.

To circumvent the provisions of the PWD, shell companies are set up and used in foreign labour subcontracting and cross-border labour recruitment.⁶¹ Typically, a shell company is set up in a Member State with low social contributions to employ workers to be posted exclusively to another Member State (with higher social contributions), with the objective of making marginal profits on the social contributions.⁶²

This use of shell companies, presented in this paper as the second category of shell companies – **'letterbox' companies**, to abuse EU free movement rules clearly **hinder worker protection and puts social protection systems at risk**.⁶³

3.2. Impacts of the identified risks

The use of shell companies in conjunction with the possibility of anonymity, treaty shopping and circumvention of the provisions of the PWD, can amplify and facilitate tax avoidance, tax evasion, money laundering and corruption. The impacts of tax avoidance, tax evasion, money laundering and corruption on the EU has been underlined by existing literature and is summarised in Table 1.

Table 1 – Impacts of the identified risks

	Economic impacts	Political and social impacts
Risks relating to money laundering ⁶⁴	Loss of tax revenue Productivity loss Unfair competition	Development of criminal activities Undermining of political stability
Risks related to tax evasion and tax avoidance ⁶⁵	Loss of tax revenues	Threat to social contract
Risks related to corruption ⁶⁶	Negative effect on GDP Lower economic output and growth	Decreased trust in institutions Rise in inequality Decreased public satisfaction with governments and their life in general Negative effect on the smooth functioning of public institutions Diversion of public action from intended purpose
Risks of abuse of labour and social rights	Loss of tax revenues	Rise in inequalities Diminished worker protection

Source: Authors' own compilation

⁶¹ A. Heinen, Dr A. Müller and B. Kessler, [Liability in subcontracting chains: National rules and the need for a European framework](#), European Parliament, 2017.

⁶² J. Cremers, [Letter-box companies and abuse of the posting rules: How the primacy of economic freedoms and weak enforcement give rise to social dumping](#), ETUI Policy Brief, 2014, pp. 1-5.

⁶³ [Hunters game: How policy can change to spot and sink letterbox-type practices](#), ETUC, 2016, p. 87 and following.

⁶⁴ B. Unger, *The Scale and Impacts of Money Laundering*, 2007, pp.110-112.

⁶⁵ Bringing transparency, coordination and convergence to corporate tax policies in the European Union, Part I: [Assessment of the magnitude of aggressive corporate tax planning](#), EPRS, European Parliament, 2015.

⁶⁶ [The Cost of Non-Europe in the area of Organised Crime and Corruption Annex II - Corruption](#), EPRS, 2016.

The data considered in the previous chapter allows us to consider the scale of Member State and EU losses through the use of EU shell companies to be serious. However, as it was not possible to determine the exact number of shell companies in the EU, the losses in terms of GDP cannot be estimated. It is however possible to ascertain that shell companies, when used for money laundering, tax evasion, tax avoidance, corruption or abuse of labour and social rights have a negative impact on EU GDP (see Table 1).

In addition, existing research suggests that money laundering, tax evasion and corruption create unequal societies, higher levels of organised crime, weaker rule of law, reduced voter turnout in national parliamentary elections and lower trust in EU institutions.⁶⁷

3.3. Mitigating factors

When shell companies are used to avoid paying taxes in the Member State where they are due or to avoid labour or social legislation, they undermine the functioning of the internal market. The EU has for that reason taken some targeted measures to try to mitigate the risks associated with shell companies.⁶⁸

First, the EU tried to mitigate use of undue advantage of legal provisions by companies, mainly through the adoption of transparency provisions. More recently, the EU has put in place policies mitigating the anonymity surrounding companies, including shell companies.

Taking a more radical approach, one Member State, Latvia, has recently introduced a legislation making it illegal to cooperate with shell companies. It remains to be seen how this will play out in practice.

⁶⁷ [The Cost of Non-Europe in the area of Organised Crime and Corruption Annex II - Corruption](#), EPRS, 2016.

⁶⁸ In addition, it is to be noted that the EU has tried to mitigate the risks posed by shell companies by preventing SE companies (Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE)) from being used as shell companies.

Latvian ban on shell companies

In April 2018, Latvia introduced a prohibition on cooperation with shell companies. Banks, intermediaries and investment management companies are prohibited from establishing and maintaining business relationships or to executing transactions with shell companies. For that purpose, Chapter I of the [Law on the Prevention of Laundering the Proceeds from Criminal Activity \(Money Laundering\) and of Terrorist Financing](#) defines shell companies as legal persons characterised 'by one or several of the following indications:

- a) has no affiliation of a legal person to an actual economic activity or the operation of a legal person forms a minor economic value or no economic value at all, and the subject of the Law has no documentary information at its disposal that would prove the contrary;
- b) laws and regulations of the country where the legal person is registered do not provide for an obligation to prepare and submit financial statements for its activities to the supervisory institutions of the relevant state, including the annual financial statements;
- c) the legal person has no place (premises) for the performance of economic activity in the country where the relevant legal person is registered'.

3.3.1. Main policies mitigating the use of shell companies to take undue advantage of legal provisions

In a recent move, the EU has adopted, or is in the process of adopting, measures indirectly targeting the use of shell companies for treaty shopping. This is the purpose for instance of the changes introduced to the **Parent-Subsidiary Directive** in 2015, aiming to make it easier for Member States to combat certain types of tax fraud and tax evasion.⁶⁹

Furthermore, recently adopted Council Directive 2016/1164/EU⁷⁰ (also referred to as the **Anti-Tax-Avoidance Directive** (ATAD)) contains five legally-binding anti-abuse measures that all Member States should apply against common forms of aggressive tax planning:⁷¹

- the controlled foreign company (CFC) rule: to deter companies from profit shifting to a low/no tax country. CFC rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company becomes taxable on this attributed income in the state where it is resident for tax purposes;
- the switchover rule: to prevent double non-taxation of certain income;
- exit taxation: to prevent companies from avoiding tax when re-locating assets;
- interest limitation: to discourage artificial debt arrangements designed to minimise taxes;
- the general anti-abuse rule: to counteract aggressive tax planning when other rules don't apply.

In addition, in 2017, Council adopted [Directive \(EU\) 2017/952](#) amending Directive (EU) 2016/1164 as regards **hybrid mismatches** with third countries. A hybrid mismatch is a situation where a cross-

⁶⁹ The new provision specifies that the Member States shall lose the benefit of the directive in cases of an arrangement put into place for the main purpose of obtaining a tax advantage that defeats the object or purpose of the directive. [Council directive \(EU\) 2015/121](#) of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

⁷⁰ [Council Directive \(EU\) 2016/1164](#) of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

⁷¹ Member States should apply these measures as from 1 January 2019.

border activity is treated differently for tax purposes by the countries involved, resulting in favourable tax treatment. Hybrid mismatches are used as aggressive tax planning structures, which in turn trigger policy reactions to neutralise their tax effects. The directive seeks to neutralise mismatches by obliging Member States to refuse the deduction of payments by taxpayers or by requiring taxpayers to include a payment or a profit in their taxable income.⁷²

The European Commission also relaunched the **common consolidated corporate tax base** (CCCTB) proposal⁷³ in 2016, in part to fight the possibility of using shell companies for profit shifting and transfer pricing. The Commission views this proposal as attributing income to where the value is created, thus combatting aggressive tax planning in determining where real economic activity takes place.

As the table below shows, these multiple measures were adopted only recently. Some of them are not yet in force, others include measures that should be implemented in the near future. It is then too soon to evaluate the impact of these measures.

Table 2 – Directives mitigating the use of shell companies to take undue advantage of legal provisions and their transposition deadlines

	Main expected effect on risky shell companies	Transposition deadline
Parent-Subsidiary Directive	Member States shall withdraw the benefit of the directive in cases of an arrangement put in place for the main purpose of obtaining a tax advantage.	31 December 2015
Anti-Tax-Avoidance Directive (ATAD)	Exit taxation rules - aimed at preventing the erosion of the tax base in the EU country of origin when high-value assets are transferred, with ownership unchanged, outside the tax jurisdiction of that country. The directive gives taxpayers the option of deferring the payment of the amount of tax over five years and settling through staggered payments, but only if the transfer takes place within the EU. Controlled foreign company (CFC) rule: reattributing the income of a low-taxed controlled foreign subsidiary to its more highly taxed parent company. As a result of this, the parent company is required to pay tax on this income in its country of residence.	31 December 2018 - with some exceptions

⁷² C. Remeur, [Hybrid mismatches with third countries](#), EPRS, European Parliament, 2017.

⁷³ Proposal for a Council Directive on a Common Corporate Tax Base, [COM\(2016\) 685](#).

Hybrid Mismatches Directive	Neutralises mismatches by obliging Member States to deny the deduction of payments by taxpayers or by requiring taxpayers to include a payment or a profit in their taxable income.	31 December 2019 - with some exceptions
Public country-by-country reporting (CBCR) by multinational enterprises	Provides for country-by-country reporting to tax administration by multinational companies (with annual consolidated revenue higher than €750 million). The proposal intends to highlight the high level of banking activity in countries with a low level of real economic activity.	Not yet adopted
Common corporate tax base (CCTB) and common consolidated corporate tax base (CCCTB) proposals	Provides for the determination of a single set of rules for calculating the corporate tax base. The intention is that the proposed CCTB is a step on the way towards re-establishing the link between taxation and the place where profits are made, via an apportionment formula to be introduced through the new CCCTB proposal.	Not yet adopted

Source: Authors' own compilation

In addition to those directives, [Council Directive 2016/881/EU](#) (DAC 4) will help transparency and may be able to help in identifying certain shell companies. The directive requires multinational groups located in the EU or with operations in the EU, with total consolidated revenue equal or higher than € 750 000 000, to file a **country-by-country report**. The country-by-country report will include information for every tax jurisdiction in which the MNE group does business, on the amount of revenue, the profit before income tax, the income tax paid and accrued, the number of employees, the stated capital, the retained earnings and the tangible assets. In this way it should help to identify those shell companies in the EU that are used by large multinational groups. Furthermore, a proposal to make this country-by-country reporting publicly available is still pending in the Council.⁷⁴

In addition, the OECD, through its 'base erosion and profit shifting' action plan (known as BEPS), is also taking action to fight corporate tax avoidance, including by shell companies. The BEPS action plan, endorsed in 2015, has 15 actions, covering elements used in corporate tax-avoidance practices

⁷⁴ European Commission, Proposal for a directive of the European parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, [COM\(2016\) 198](#).

and aggressive tax planning schemes.⁷⁵ Two specific actions could have an influence on the risks associated with treaty abuse by shell companies, namely actions 6 and 7.

OECD BEPS action 6 gives guidance and recommendations on how to structure tax treaties to **prevent treaty shopping**. As identified in Section 3.1.2, shell companies are used for treaty shopping. Therefore, this action, which tries to ensure that only those corporations that have real activity within a country should be able to receive the benefits under a tax treaty with that country, is of particular relevance in the fights against the use of shell companies for treaty shopping. The OECD recommends introducing a principal purpose test rule (PPT rule) to tax treaties to combat their abuse. The PPT rule contains two elements: a reasonableness test and a principal purpose test.⁷⁶

OECD BEPS action 7 is aimed at **preventing the artificial avoidance of permanent establishment status** that can be achieved by setting up a shell company. This addresses techniques used to inappropriately avoid permanent establishment – and related taxation – irrespective of the place where the essential business activities of an enterprise are carried out. Through limitations-on-benefits (LOB) rules and principle purpose test (PPT) rules, countries can determine whether a company is a 'true resident' and not merely abusing treaty provisions. New tougher standards of what it means to have a presence in a country will mean that companies will have to pay the appropriate amount of taxes based on their actual permanent establishment status.

Some OECD BEPS actions are implemented through a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the 'Multilateral Instrument' or 'MLI').⁷⁷ The MLI covers over 75 jurisdictions, including all EU Member States, and entered into force on 1 July 2018. The effects of proper implementation of the MLI and its impact on efforts to mitigate the anonymity and treaty shopping associated with the use of shell companies remain to be seen.

With regard to **tackling the circumvention of the Posting of Workers Directive by setting up shell companies**, the 'Enforcement Directive'⁷⁸ was adopted in 2014. Its Article 4 includes an assessment of genuine establishments based on a number of elements, with the test designed to identify where the core activities of an enterprise actually take place. This provision is particularly interesting, as it is intended to ensure that the company posting employees is not a shell company.

All these provisions are aimed at reducing the risk of shell companies with no substantial activity being used for tax avoidance and labour legislation purposes. As they were all introduced very recently, there is not yet sufficient evidence to evaluate their impact.

⁷⁵ C. Remeur, [Understanding the OECD tax plan to address 'base erosion and profit shifting'-BEPS](#), EPRS, European Parliament, 2017.

⁷⁶ D. Weber, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', *Erasmus Law Review*, 2017.

⁷⁷ See OECD website: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>.

⁷⁸ [Directive 2014/67/EU](#) of 15 May 2014 on the enforcement of Directive 96/71/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.

3.3.2. Policies mitigating the secrecy surrounding shell companies

In 2015, the EU adopted the fourth Anti-Money-Laundering Directive (AMLD).⁷⁹ Its Article 30(1) reads as follows: 'Member States shall ensure that corporate and other legal entities incorporated within their territory are required to obtain and hold adequate, accurate and current information on their beneficial ownership, including the details of the beneficial interests held'. This requirement that all legal entities incorporated within EU Member States, including shell companies, have to register their beneficial ownership in a central registry should decrease the appetite for anonymous shell companies within the territory of the EU. This means that information on individuals who ultimately own or control more than 25 % and one share of a company will need to be obtained and held by the company and provided to the central register. It is up to each Member State to decide whether to make the data available to the public. This information will be accessible via the Member States' competent authorities, (financial intelligence units (FIUs), obliged entities within the framework of customer due diligence (CDD) and, since the publication of the fifth Anti-Money-Laundering Directive,⁸⁰ by any member of the general public. Undoubtedly such a register will make it easier to prevent many types of crime. As the transposition deadline for the 4th ALMD was 26 June 2017 and the deadline for the fifth AMLD is 10 January 2020, it is also difficult to evaluate properly the impact of this measure on the creation of anonymous shell companies within the EU.

The fifth AMLD has expressly included in Article 30 the obligation for Member States to ensure that breaches of that provision are subject to effective, proportionate and dissuasive measures or sanctions.

⁷⁹ [Directive \(EU\) 2015/849](#) on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, later amended by [Directive \(EU\) 2018/843](#) of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU (Text with EEA relevance).

⁸⁰ [Directive \(EU\) 2018/843](#) of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU.

4. Conclusions

The term 'shell company' has been used widely in recent years, often interchangeably with terms such as 'letterbox or mailbox company', 'special purpose entity', 'special purpose vehicle' and similar. A review of literature reveals that shell companies are defined differently in different contexts. For the purpose of this paper, 'shell' companies broadly fall into one of the following three categories: 'anonymous shell companies', 'letterbox companies', and 'special purpose entities'. The main common feature of the above three types of shell companies is the absence of real economic activity in the Member State of registration. This generally means that such companies have no (or few) employees, and/or no (or little) production, and/or no (or little) physical presence in the Member State of registration.

Reliable data on shell companies is however not available, especially in the case of the first two types of shell company. This is why this study approaches the problem by looking for proxies as possible indicators of the presence and magnitude of shell companies in the EU, based mostly on macroeconomic indicators. These indicators are: the numbers of foreign-owned companies in a Member State; the ratio of foreign direct investment (FDI) to GDP of a Member State; and the profitability gap between foreign and domestic companies in a Member State.

The first indicator – the number of foreign-owned companies in a Member State – finds that the UK is the most popular target country, followed by three central and eastern European Member States and France. The second indicator – ratio of FDI to the GDP of a Member State, showed that several Member States stand out with particularly high values of FDI as a percentage of GDP. These are Luxembourg, Cyprus, Malta, the Netherlands, Ireland, Hungary and Belgium. Finally, a closer look at the profitability gap between foreign and domestic companies in a Member State reveals that some Member States have systematically higher profitability in the foreign-controlled sector than in the local sector. These are Ireland, Luxembourg, the Netherlands, and Belgium.

Shell companies do not necessarily present risks because of what they are. However, associated with anonymity, circumvention of the Posting of Workers Directive and treaty abuse, they can be misused and thus generate serious risks of tax avoidance, tax evasion, money laundering and abuse of social rights. Such misuses of shell companies have an impact on the economy and society as a whole, with economic, security and social consequences. This can negatively affect GDP, not least because of the loss in tax revenue, productivity loss and unfair competition. In addition, it can lead to broader political and social impacts, such as the development of criminal activities, a rise in inequalities and decreased trust in public institutions.

In the past few years, the European Union has adopted a whole series of policies and legislation aimed at addressing the above problems of tax avoidance, tax evasion, money laundering and abuse of social rights. However, this move is recent, and many of the regulatory provisions contained in EU legislation have yet to produce their full effects, or even to come into force. In addition, several relevant legislative proposals are being negotiated at the time of writing this paper (such as the common consolidated corporate tax base and public country-by-country reporting).

It is therefore too early to assess how these recent pieces of legislation will perform on their own, and in combination with other related pieces of legislation. Given the interconnections between the relevant legislative acts, the European Parliament could consider requesting a fitness check after several years of implementation of these acts. A fitness check (i.e. an evaluation of a group of interventions that have some relationship with each other) could lead to a more comprehensive picture of how these legislative and policy interventions have performed against expectations.

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In April 2018, the European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) requested the European Parliamentary Research Service (EPRS) to produce a study on shell companies in the European Union, the main common feature of which is the absence of real economic activity in the Member State of registration.

Prepared by the Ex-Post Evaluation Unit (EVAL) and the European Added Value Unit (EAVA) of EPRS, this study aims to contribute to a better understanding of the phenomenon of shell companies, by seeking to estimate the incidence of such companies, by constructing a set of 'proxy' indicators at Member-State level. It also explains the main risks associated with shell companies, and current policies aimed at mitigating the risks identified.

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