

## SHELL COMPANIES : A DEFUNCT

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### INTRODUCTION

The fact that there are 15 lakh registered companies in India, and only 6 lakh out of these companies file their annual returns which categorically implies that colossal number of the companies may be indulging in financial irregularities and therefore warranted a stringent action against these companies.<sup>2</sup> Though not defined under the Companies Act, shell companies meet statutory requirements in letter to remain unheeded and unrecognised and have inconsequential business activities that are used in tax evasion, money laundering, and converting black money into white.

The repercussion of demonetization, that an integrative, consultative and inter-regulatory “search and action” initiative has been taken by Modi government to track black money which is being laundered and tripped by using the façade of front companies. Out of approximately 17 lakh (1,720,682) registered companies<sup>3</sup>, the bank accounts of around 2.10 lakh shell companies have been iced after they were removed from the Business Register and a total of 1, 06,578 directors were identified by the ministry for disqualification under Section 164(2) (a) of the Companies Act, 2013 as of September 12, 2017 as the government intensifies its campaign against black money.<sup>4</sup> It is suspected that above-mentioned firms have been used as shell companies to evade taxes and launder black money. Some of the shell companies include Sundar Pharmaceuticals Private Limited, Udgam Construction Private Limited.<sup>5</sup>

### WHAT ARE SHELL COMPANIES?

Before beginning let us look at what exactly<sup>6</sup> is a shell company? Since there is no universally accepted definition however, different forums

have provided their own definition.

As defined by The U.S. Securities and Exchange Commission<sup>7</sup>, Shell Company is referred to a registrant, other than an asset-backed issuer, that has no or nominal operations, and either:

- no or nominal assets;
- assets consisting solely of cash and cash equivalents; or
- assets consisting of any amount of cash and cash equivalents and nominal other assets;<sup>8</sup>

Organisation for Economic Co-operation and Development (OECD) defines it as:

*“A company that is formally registered, incorporated, or otherwise legally organised in an economy but which does not conduct any operations in that economy other than in a pass through capacity. Shells tend to be conduits or holding companies and are generally included in the description of special purpose entities.”<sup>9</sup>*

Shell companies are also called as ‘Paper’, ‘Briefcase’, Post-box’ and Dabba companies.<sup>10</sup> These companies do not indulge in ordinary business function that influence the information obtained on their existence. These activities include creation of website, rent of office, purchase of supplies and equipment.<sup>11</sup> Shell companies are not always formed to launder money or evade tax or for illegal purpose. Sometimes, the company which was registered did not start its business for some genuine reasons or company started its business but went into loss for failure of business or on economic grounds. So, shell companies are not in themselves illegal rather they do have legitimate or legal business purposes for instance, In case of a merger two companies will combine to form a neutral shell company while in case of Joint venture shell company

may be used to gain equal legal position for both parties in third jurisdiction. Other legitimate purposes are reverse merger, where a private company acquires majority of shares of a shell company listed in stock exchange to go public, as separate identities and to create distinctive equity.<sup>12</sup>They are also used for raising funds for a start up.<sup>13</sup>Although, these companies are also used for illegal purpose such as to evade tax, to launder money and to manipulate the market by use these shell companies to back the main company since these shell companies function at multiple layers.<sup>14</sup>These enable the entities to hide their identity of the owner and to keep the assets out of the reach of creditors and other claimants.

### HOW SHELL COMPANIES ARE USED IN MONEY LAUNDERING, CREATION AND ROUND TRIPPING OF BLACK MONEY?

Shell companies are majorly used as pass through's for money laundering activities. Money laundering is a method used by business persons to conceal illegally obtained funds. This is a method where multiple layers of transactions take place through which money flows so that it becomes complicated and misleading for anyone to trace the record. The end of this process is to conceal the identity of the original party; however money ultimately flows back to the launderer. Methods are generally classified in three steps:

- **Placement** : In this method, the money moves from its source. The identity of the source is generally concealed. In placement, the money is put into circulation. This can be done by depositing it in financial institutions, businesses, shops, etc. It can be done through many more stages such as bank complicity (when the owners of the financial institutions themselves connive with the launderers); currency smuggling (the moving of currency out of a country – commonly referred as the process of round tripping); currency exchanges (the exchange of money becomes easy with a nation which has liberalized

its economy providing room for smooth flow).

- **Layering**: Covering and layering the source as well as the trail of the laundering acts to make it harder to trace for law enforcement authorities; generally done by converting the illegal money into monetary instruments using demand drafts, cheques, money orders etc; and purchasing assets and materials and then selling them off.

- **Integration**: The process of putting the illegal or laundered money back into the economy as normal earnings mainly through financial institutions such as banks. This can be done by using shell companies to purchase property, thus the money received looks normal earnings; using foreign banks to launder money bank into economy; the use of false invoices for import and export.

- For elaborate understanding of the process, let us look at a hypothetical case. A company called *Orizone Ltd.* is a successful company actively engaged in the business of manufacturing sanitary ware. Running business for several successful years, it is now trying to launder money to further expand its financials. For doing so, it writes a cheque to a shell company called *Summershine Ltd.*, created for illicit purposes by business persons related with *Orizone* itself. *Orizone* records the paid money as commission. After cutting a small portion, *Summershine* returns the money as cash back to *Orizone*, thus making it appear legit on records. *Orizone* in this process has received taxable money, and converted white into black. Next, *Summershine* shows the money received by *Orizone* as contractual income rather than commission, to avoid paying tax. To escape payment of income tax on this amount, *Summershine* in its records shows that the amount is paid to another shell companies as due amount for previous contractual obligation. The money is thus then transferred to another set of shell companies. Let's call them A, B, C, and D.

These shell companies record the amount paid to them as their share capital. Although no actual money has been flowed to their account, it still has been shown as such in their records. These shell companies can be sold to anyone interested who wants to convert the black money into white. Any such interested person can just buy the shares of this company, at a discount (e.g. paying Re 1 for a share whose face value is Rs. 100). This interested buyer has thus gained control over the company since the assets of these companies have been made to appear as legitimate, thus direct conversion of the black money into white, with only paying some part of the cost in white. The buyer can now arrange payments of this cash through various banks. Thus the shell company here has acted as a bridge on which white money passes off as black and black money passes off as white. Thus, it is one of the many ways that money laundering unfolds.

- These companies shows business on their books by way of contract which are not even remotely related to their business. The purpose might be to increase their turnover over their year.

### **DEREGISTRATION OF SHELL COMPANIES:**

Section 164 of the Companies Act provides that “If any person who is has been a director in a company which has not filed financial statements or annual returns for any continuous period of three financial years shall not be eligible for re-appointment as a director in that company or appointed in other company for a period of five years from the date on which the said company fails to do so.”<sup>15</sup>Section 248 of the Companies Act incorporates a provision that, “Registrar has power to remove name of a company from register of companies where company fails to commence its business within one year of its incorporation or the subscribers to the memorandum have failed to pay their subscription within a period of 180 days or where a company is not carrying

on any business or operation for a period of two years.”Further Section 167(1) (a) provides that on suffering the aforesaid qualification, the director shall vacate the office. In addition to this, Ministry of Corporate Affairs revised the process of striking off defaulting Shell Company’s name through fast track exit mode under the provisions of Section 560 of Act.

### **INITIATIVES/STEPS TAKEN AGAINST THE SHELL COMPANIES**

This process had started way back in August, 2014 when the Union Ministry of Corporate Affairs came up with the Company Law Settlement Scheme (CLSS) that granted a period of two months to all the defaulting companies to file their pending annual returns. It even levied lesser fee for such filing.<sup>16</sup>

1. On **10.2.2017**, PMO takes a harsh punitive action by freezing the bank account, striking off the names of dormant companies, invocation of Benami Transactions (Prohibition) Amendment Act, 2016 and by setting up “**Task force on shell companies**” to monitor the actions taken against shell companies.<sup>17</sup>

2. On **9.6.2017**, MCA shared with SEBI, a list along with a letter from “Serious Fraud Investigation Office” (SFIO), containing the database and inputs of shell companies and was asked to initiate prerequisite actions under its regulations.

3. On investigation SEBI found that the companies identified as shell companies by SFIO and MCA were involved in:

- Misrepresentation of their financials and business in violation of listing regulations,
- Misusing the books of account,
- Mishandling funds of the companies by facilitating “accommodation entries to the detriment of minority shareholders” and, thus relinquishing on the fiduciary duty cast on the board for superintending shareholders and the crucial management personnel.

4. On **7.8.2017**, SEBI took “pre-emptive interim measures” by putting trading restrictions on the promoters and directors of the listed shell companies; so that they do not exit the firm till the detailed probe get completed.<sup>18</sup> It put restrictions on companies who operate from the same premises and the number of companies in which a person can become a director.<sup>19</sup>

5. On **9.8.2017**, SEBI asked the bourses to proffer a report after seeking auditor’s certificate from all listed companies.

6. On **11.8.2017**, stock exchanges not only initiated action against 331 suspected companies but barred them from trading.

7. Further, MCA cancelled the registration of around 2, 09,032 defaulting companies and the Finance Ministry directed banks to restrict operations of bank accounts of such companies by the directors of such companies or their authorized representatives.

8. On **21.8.2017**, SEBI and IT Dept. also started investigating the role of about 100 brokerages which played an indispensable role in allowing shell companies to trade in listed penny stocks and launder approximately Rs. 16,000 Crores by undermining KYC norms.<sup>20</sup>

9. On **12.9.2017**, MCA also identified 1, 06,578 directors for disqualification under Section 164(2) (a) of the Companies Act, 2013 and from being on the boards of any company for a period of five years.<sup>21</sup> As on November 1st, 2017 MCA has directed state governments to enlist the property owned by shell companies and take them under custody. The shell companies are now restricted from selling or transferring the said property that are now kept under the custody of the district collector.

10. On **14.9.2017**, MCA and Central Board Of Direct Taxes (CBDT) signed a MoU to facilitate the sharing of data and information in methodical and punctilious manner to curb the menace of shell companies, money laundering

and black money, and to prevent misuse of corporate structure by shell companies for various illegal purposes.<sup>22</sup>

11. On **19.9.2017**, the MCA employed one of its kinds “**Naming and Shaming**” exercise by making public the name of the directors who are disqualified for not filing the financial statements and annual returns for three consecutive years.<sup>23</sup>

## CONCLUSION

The shell organization expression alludes of the substance which doesn’t need whatever huge assets, free operations, current business exercises alternately workers. Previously, short, it can wood make expressed that the shell agency will be an non-operational shares of the organization that might have fiscal advantages for example, stock, cash, properties, and so forth from claiming different organizations. Shell companies, as opposed on average companies, don’t direct conventional business exercises that influence those data acquired around their presence. Those Common benefits of the business operation incorporate various exercises for example, enrolment inside the chamber from claiming trade, commerce, making from claiming website, buy or lease of an office and also buy about supplies and supplies. Moreover, shell organizations would likewise utilize to Different real purposes also for example, merges or joint ventures. These days the powers bring place greater thoughtfulness regarding that issue for tax evasion. It need been assessed that this specific criminal movement additions trillions upon billions of dollars consistently. Tax evasion will be depicted concerning illustration the system that plans will change over sick gotten additions or something like that called grimy cash so as with make those feeling that such cash starts from a real hotspot. Tax evasion will be principally utilized around the world on hide criminal exercises that are by and large connected for medication alternately arms trafficking, terrorism, extortion, insider trading,

bribery, illegal charge practices, showcase control and alternately other criminal offences. Cash launderers for the most part utilize both the shell furthermore front organizations for their illegal purposes. These organizations could make made extraordinarily for such reasons. Culprits every now and again utilize monetary transfers will hide the genuine sources of the stores also will blend those filthy furthermore clean cash together. These transfers need aid mostly being named as “expenses” to gathered merchandise or services, be that as indeed they are minor constructions of real, certified transactions made through fake receipts, fake balance sheets.

### (Endnotes)

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