

Challenges to the Shell Companies in India

General Meaning of Shell Company:

The Companies Act does not define “**Shell Company**” and no other piece of Legislation provides for the guidance on what does it constitutes; however, the general definition is understood as:

“A shell company is a company that exists only on papers, without active business operations or significant assets and has no office or employees. These types of companies are not necessarily be illegal, but they are sometimes used illegitimately, such as to disguise business ownership from law enforcement or the public. Legitimate reasons for a shell company include such things as a start up using the business entity as a vehicle to raise, funds, conduct a hostile takeover or to go public.”



Background and its rapid evolution:

Historically, these companies were deliberate arrangements created to benefit from favourable tax treaties. This explained the limited economic activity. However, over time these innocuous companies were used for unscrupulous activities.

Today, the ascent of a shadow economy is no surprise. Though this system has existed since the very inception of the term ‘economy’, what’s surprising is how shell companies are mushrooming around the world. The clandestine activities which govern these shell companies, like carrying out business transactions for cash, evading taxes, and dodging regulations flourish during times of financial uncertainty.

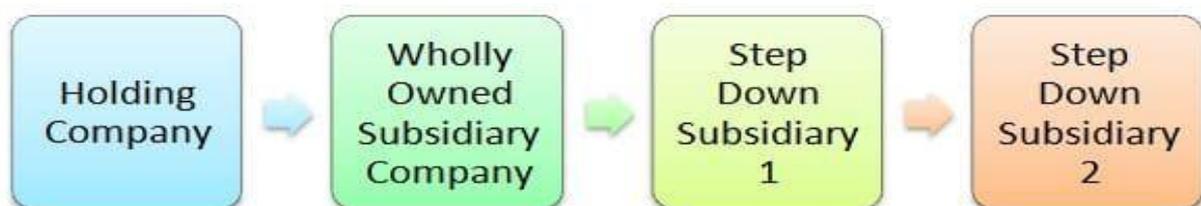
The Need to know about the Shell Company:

If you end up investing in a shell company, or in entities which set up a shell company, your money could be used for illegal purposes and may not even be recoverable given the government crackdown on these entities.

**BE ALERT OF
FAKE
COMPANIES**

Is a Shell Company always illegal?

A Shell Company may be legal or illegal. There are many shell companies which work within the legal limits. For example, a company may create a subsidiary to look after only its HR functions but not to engage in its main trade or business. It would be a shell company but not illegal.



The term ‘shell company’ is mostly used to refer illegal shell companies and such companies should be identified based on purpose of their creation.

Objectives and purpose of formation of Shell Companies:

The below mentioned purposes are beyond the permitted legal limits and can result into illegal shell companies (the list is not exhaustive):

1. Companies formed as multiple layers to hide the identities of real / beneficial owner such that it becomes difficult to locate the precise ownership, persons or business operations.
2. Tax evasion/ Tax avoidance
3. For money laundering and siphoning off the black money. This is the major reason why shell companies suddenly started being discovered during the demonetization drive of November 2016. A significant number of shell companies were used to deposit surplus cash so that there would not be excessive deposits of cash by the original holders. There were instances of shell companies being created based on stolen/ fake identities of people who had no idea about how their identity documents were being used.
4. For Ponzi schemes. Fraudsters can use shell companies for defrauding people by creating Ponzi schemes so that eventually, when the fraud is discovered, the box or the company is all that finally remained and the real people behind the entity would have escaped, probably out of the country.
5. For shifting incomes to tax neutral jurisdictions. This happens in international transactions to evade tax in the source country.

Laws Violated:

Below are major laws violated by shell companies having connection with India through conducting the above activities in illegal way:

1. The Companies Act, and in specific The Companies (Restriction on the number of layers) rules, 2017
2. Securities and Exchange Board of India Act and rules made thereunder
3. Benami Transactions Prohibition (Amendment) Act, 2016
4. Prevention of Money Laundering Act, 2002
5. Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015
6. Indian Penal Code
7. The Income Tax Act, 1961, and in specific PoEM Guidelines issued by CBDT



Challenges around the Shell companies in India:

1. Firstly, there is no legal definition for Shell Company under Companies Act, 2013 or under any other corporate law
2. Secondly, there is no specific law to deal with only the Shell Companies. The resent procedures are done under the Benami Transaction (Prohibition) Amendment Act, 2016; Prevention of Money Laundering Act, 2002; the Companies Act, 2013, and Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015
3. Thirdly, it is difficult to gather data on transactions and difficult to distinguish between genuine and illegal shell companies. Transactions from multiple accounts can make tracking difficult.

Existence of complex corporate structure in India also makes it difficult to find the shell companies.

Examples of Major Fraud Disclosures about the Shell companies:

- In 2013, Offshore Leaks
- In 2016, Panama Papers



How Shell companies turn black money to white and vice-versa?

There are numerous procedures for converting the white money to black and vice-versa. One of such procedures as followed is described below in nutshell for basic understanding:

- 1st. Company A, in need of cash for various transactions, **writes a cheque to shell company B** and accounts for it as payment of commission. Company B returns the money as cash (after taking a small cut). This way, company A has obtained cash for various illicit payoffs, but has managed to account for it in its books (making it tax deductible). In this process, **white money is converted to black.**
- 2nd. Company B shows the 'income' from company A as **contractual income** instead of commission to avoid GST.
- 3rd. To avoid income tax on these earnings, **company B shows payments are made to another shell companies towards fulfilment of contracts.**
- 4th. **The money is routed to a further clutch of companies** – C, D, E & F, who account for it as share capital. All these money flows are notional – no actual money flows to these firms.
- 5th. **These four companies can now be 'sold'** off to others who want to convert black money to white. Anyone who wants to do this, buys the shares of the company at a huge discount to book value (i.e. paying say, ₹1 for a share worth ₹50). Depending on your requirements and how much you want to launder, there are shell companies of different size available.
- 6th. By doing this, **the buyer has gained the control of a company**, whose assets are 'clean' by only a fraction of the cost in white. It's similar to buying land by paying part of the value in black and part in white.
- 7th. The buyer can bring in the black money into the company – and **convert it into white** – by organising small cash payments through various banks, and into the account of the company.
- 8th. The shell company operator acts as an intermediary or a broker between two different players. **One wants to convert white to black and the other wants to do the opposite.**

Status of companies registered in India:

Data from the ministry of corporate affairs showed that 67% of the 17.87 lakh companies registered in India were active at the end of July 2018, amid the government continuing its clampdown on shell companies. There were more than 11.98 lakh active companies as of July-end. Active companies are those carrying out normal business activities and make their statutory filings to the stock exchanges on time.

Out of the total number of 17.87 lakh registered companies in India, 5.43 lakh were closed as on July 31, and 1,381 were classified as dormant. As many as 38,802 companies were in the process of being struck-off while 6,111 were under liquidation. Among those struck off, 103 companies were in the process of being reactivated, according to the ministry.

In terms of economic activities, 3.74 lakh companies were into business services and 2.37 lakh entities were engaged in manufacturing and other lines of work. Business services include information technology (IT), research and development, law and consultancy.

Government of India Initiatives:

Formation of Task force (for Tackling the malpractices through Shell companies) and its composition:

The actions began with the financial regulators launching a two-pronged attack on shell companies. The '**Task Force**' was set up in February 2017 by the Prime Minister's Office under the joint Chairmanship of the Revenue Secretary, MoF and Secretary, MCA with a mandate to check in a systematic way, through a coordinated multi-agency approach, the menace of companies indulging in illegal activities including facilitation of tax evasion and commonly referred to as 'Shell Companies'. Department of Financial Services, CBDT, CBEC, CBI, ED, SFIO, FIU-IND, RBI, SEBI, DG GSTI and DG-CEIB are its Members.



The Task Force on shell companies has met 8 times since its constitution and has taken pro-active and coordinated steps to check the menace of shell companies.

Actions proposed to be taken by members of Task Force in tackling the shell companies:

- Government had requested the Reserve Bank of India (RBI) for freezing of accounts of the defaulting companies who have long exceeded the stipulated time limit, for filing the financial statements and returns under the Companies Act, 2013.
- To help the genuine corporates in regularizing their pending returns, the Condonation of Delay Scheme, 2018 was brought in by Central Government. It was effective from 1.01.2018 to 1.05.2018
- SEBI has asked stock exchanges to verify the credentials of suspect companies by appointing an independent auditor. If exchanges do not find appropriate fundamentals about the existence of the company, the stock can be delisted.
- Centre has initiated action against more than two lakh shell companies as part of Operation Clean Money.
- Ministry of Corporate Affairs (MCA) and Central Board of Direct Taxes (CBDT) have signed MoU for automatic and regular exchange of tax information. The purpose of the MoU is to curb the menace of shell companies, money laundering and black money in the country and prevent misuse of corporate structure by shell companies for various illegal purposes.
 - Income tax act provides that a company would be treated as resident in India on the one of the conditions that, if its Place of Effective Management (PoEM) in the previous year was in India, thereby making many shell companies fall under its scope
- Serious Fraud Investigation Office (SFIO) is creating a database of shell companies, and sharing to all required regulators



- Task Force has directed all member Law Enforcement Agencies to send to Institute of Chartered Accountants of India (ICAI), the details of action taken by them against Chartered Accountants involved in such malpractices, if any.

Achievements of the Task force since its formation:

The major achievements of the Task Force include the compilation of a database of shell companies by SFIO. This database, as on date, comprises of 3 lists, viz the Confirmed List, Derived List and Suspect List. The Confirmed List has confirmed shell companies based on the information received from the various Law Enforcement Agencies of the companies found to be involved in illegal activities. The Derived List has companies identified based on 100% common directorships with the confirmed shell companies. The Suspect List has suspected shell companies and has been drawn up by SFIO using certain Red Flag Indicators.



**MINISTRY OF
CORPORATE AFFAIRS**

In the drive conducted by MCA, it targeted the shell companies with deregistration. The first point of attack was the companies which have not filed their financial statements as per Section 248 of The Companies Act 2013.

During the First Drive in the previous Financial Year 2017-18, over two lakhs companies were struck off under this section and MCA placed a list of these companies ROC wise on their website. Further MCA has also put up a list of directors

associated with these companies. The directors of the companies were disqualified to act as directors of any other entities for a period of five years. The banking operations of these companies were also restricted, and the directors were disallowed from operating their bank accounts.

And Initiatives to be taken under the 2nd drive during the current Financial Year 2018-19 and the appropriate actions will be taken.

SEBI directed to stock exchanges to initiate action against 331 suspected shell companies and ban them from trading. BSE and NSE moved 162 and 48 companies into Stage-VI of the Graded Surveillance Measure (GSM), implying these stocks would not be available for active trading.

Suggestions considered by Task Force:

One of the key issues hampering the investigations and prosecutions against entities involved in financial irregularities has been lack of a proper and uniform definition for “shell companies”. It has arrived at a criterion to define the “shell companies” and it has suggested some possible parameters to define if a company has been set up to launder money or exploit regulatory arbitrage. Government is expected to come out soon with definition of shell companies based on these suggestions.

Conclusion:

Tackling of shell companies in India is on full-fledged mode to protect the interests of the investors thereby to ensure the ease of doing business and reducing the menace of black money will over time result in higher tax revenue which will not only help the government enhance public spending but will also lower the tax burden on honest taxpayers.