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SHELL COMPANIES: AS A SOURCE TO ILLEGAL ACTIVITIES

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Abstract

Shell companies are not been defined by Indian legislature which makes it difficult for classifying companies into shell companies. These are companies which are incorporated legally and exist only on paper and have no physical transactions it is used for different purposes right from legal purpose such as reducing tax liability or protecting the firm from competitors to various illegal purpose such as money laundering, floating Ponzi schemes, Tax evasion or converting black money into white. As there is no proper legislation it becomes difficult to identify such companies. The paper discuss about various attributes of shell companies and how shell companies are used for illicit purposes and certain steps which are taken by government to curb the growth of shell companies. The paper provides for certain suggestions which could help to identify shell companies at an early stage of its incorporation and reduce its impact on the economy.

Introduction:

Indian Government has taken various initiatives to encourage people to accept the corporate business model by providing various advantages and making the incorporation of companies a less cumbersome process. With the introduction of Insolvency and bankruptcy code, 2016 and companies Act 2013 incorporation and management of companies was made easier. Many companies were incorporated due to various advantages provided by the government. However, both acts failed to resolve the problem raised by shell companies.

Shell companies have not been define in the companies Act 2013. A shell corporation or shell company is a company or corporation that exists only on paper and has no office and no employees, but may have a bank account or may hold passive investments or be the registered owner of assets, such as intellectual property, or ships. These companies just act as a vehicle for facilitating business transactions without

themselves having any significant assets or operations. These companies may be created with various intention such as it may be incorporated for tax evasion, money laundering, making money off Ponzi schemes, and for hiding the identity of the Real owner.

Shell companies are not illegal as they are not expressly prohibited by law however the utilisation of shell companies for illegal purposes which is against law and can lead to striking off the name of companies from the register of companies and shall also be punishable offence depending on the nature of the offence.

In the battle against black money, shell companies play a vital role as these companies act as a source for all the illegal activities. It is difficult to track these companies as these companies are registered just like any other normal company and have all the requirement met under the companies act and other regulations. Prime minister of Indian in his recent interview said under his government more than 1.75 lakh shell companies have been deregistered. Despite various challenges imposed by shell companies, there is no particular law or provision which regulates the operation and monitors the operations of shell companies.

Shell companies may not always be created for illegal purposes. There have been various instances where shell companies have been created for legal purpose. The Indian government has been making significant efforts to restrict shell companies from engaging in illegal activities. But, it has faced certain issues, such as lack of a legal definition for 'shell company' under any law, No specific law to deal with shell companies primarily, Existence of a complex corporate structure, which makes it difficult to track transactions from different accounts and differentiate between illegal and legal shell companies. However, There have been some serious steps taken by different government departments to tackle shell companies from being used as a source to money laundering and other illegal activities

Attributes of Shell Companies :

Though there are no specific regulations relating to the identification of shell companies various efforts have been made by different authorities to classify the company as a shell company. There are certain attributes which are common and present in all the shell companies which makes it possible to identify them. Although a shell company may not have all the attributes discussed below it will have some attributes which make it one amongst the shell companies. Even though a company met certain attribute it does not make it per se shell company it is just an

alarm for the regulatory authorities to keep a watch on them and if anything illegal happens it might be a trigger to take next step. Some of the distinctive attributes of shell companies are :

Private limited company status: All the shell companies unveiled in India had the status of private companies till date no public limited company has been found to be a shell company. There is clear reasoning behind this as private limited company are easy to incorporate and function it requires limited documentation. On the other hand public limited companies are strictly monitored by government authorities and are required to meet various regulations which make it difficult for them to operate as shell companies.

Directors and officers of the company: All the directors appointed by shell companies have little or no knowledge about the work and fraud they are committing. They are appointed just for the sake of compliance with the regulations. They make no real decision all the decisions are made at a higher level and they are merely dummy used for signing and giving validity. Another legal device or approach to optimize concealment involves the shell entity's beneficial owner or owners electing to hire a nominee as a company director. A nominee is one who holds bare legal title for another, who is designated to act in place of another in a limited way, or who receives and distributes funds for the benefit of others¹. Lack of knowledge about the law and fear of losing there jobs are the strong reasons due to which the are forced to accept the role of directors in shell companies. However there might be another reason due to which people accept the role of dummy director which is Monetary benefits. Some people just for small monetary benefits without knowing the consequences of their Act end up being part of this illegal structure.

Flow of funds in and out of the company: One of the common attributes of shell company is it involves too many transaction to make the tracking of the money cumbersome process. Many shell companies are used for money laundering and hence enormous amount of fake transactions are undertaken to make it impossible for the authorities to trace them and the process of money laundering could be completed with swift.

Shell companies and illegal activities:

¹Carl Pacini, The role of shell entities in fraud and other financial crimes, Emerald Insight www.emeraldinsight.com/0268-6902.htm

Shell companies can act as a host to various illegal activities with the motive to defraud the government and unscrupulously get away with illicit income. Shell companies act as a channel through which all the illegal activities are conducted they are incorporated sometimes in a country which are known as tax heavens where it offers individuals and businesses little or no tax liabilities in a politically and economically static environment. Transactions are made so complex that it becomes impossible to trace and find out the source of the transactions many times these shell companies act in a layered format where there are more than one layers through which transactions take place. Although these types of companies are opened in different jurisdiction the controlling authority or the decision making authority are located at a place of its primary business. The various illegal activities conducted through a shell company are:

Tax Evasions:

Shell companies are used by both well know public companies and private individuals equally for the purpose of tax avoidance and tax evasion of their primary business. Big business house use shell companies majorly to avoid tax so that their tax liability may be reduced. However tax avoidance is not considered as crime it is just seen as loophole in the current tax system of which individual or company has taken advantage of. However Tax evasion is considered as more serious issue and it is a punishable offense in India and around the world. Some of the well know tax heavens around the world are Switzerland and Panama where corporations create shell companies in these jurisdiction and park their assets in these companies and escape from paying tax on such assets.

Money laundering:

Money laundering is illegal process of making large amounts of money generated by criminal activities appear to have come from a legitimate source. Combating money laundering is a massive and evolving challenge which requires a clear and thorough understanding of the various trends and techniques being used by criminals to launder their illicit funds². Money laundering is a serious financial offence and is considered as a white collar crime. Shell companies are used for laundering money in and out of the country by involving in multiple

²Emery Kobor, "Money Laundering Trends", Hein online, Pg. 14-20.

transaction with the shell companies. Multiple shell companies are established within a complex network of relationship to carryout the scheme.

Making money of Ponzi scheme:

People and corporations use shell companies to float different Ponzi scheme. By making use of shell companies the real owner of the scheme or the person behind the scheme is difficult to trace. As the shell corporation is considered as separate legal entity of its own. The culprit tries to hide behind the corporate structure and it becomes difficult to unveil the corporate structure and find out the person behind the fraudulent scheme. In past different chit fund scam and Ponzi scheme were floated through the shell companies.

Hiding identity of Real owner:

Many benami transaction are undertaken in the name of shell companies to hide the identity of real owner of the property. Despite of enactment of the Benami Transaction Amendment Act 2016 it failed to curb the holding of assets on fake names. Still holding of assets on fake names in major concern in India and majority of the benami transaction are done with the help of shell companies where the assets are purchased and transferred to shell companies to hide the real identity of the owner.

Initiative taken by Government:

Incorporate of shell companies is not illegal in India however utilisation of shell companies for illegal purpose is considered as offence in India. Various initiatives are taken by government of India to curb the use of shell companies for illicit purposes. However in the present scenario it won't be wrong to say Indian government have failed in preventing shell companies to be used for illegal purposes. Regular investigation is carried out by the Income tax department to encounter shell companies which are engaged in illegal activities and to initiate criminal proceedings against such companies. Ministry of corporate affairs targeted shell companies who didn't file the required financial statement and deregistered around 1.75 lakhs companies in the recent years. Due to demonetisation government was able to identify a large amount of shell companies which were involved in illicit course of business. In 2017 a joint financial task force was setup to look into the effects, achievements and suggestion of task force in detail. A database of shell companies was created by serious fraud investigation office and shared with regulators.

Conclusion:

Shell companies cause a lot of hurdles in the development of the economy. It is important for the development of economy that these shell companies are identified at an early stage so that proper measures can be taken to reduce their impact on the economy. In India it might be difficult to deal with shell companies as there is no proper regulation or legislative framework available to identify and define shell companies. However at the same time it must be made sure that such legislative framework doesn't cause unnecessary impediments in working of legal entities which appear to be shell companies. This can be achieved by incorporating a proper definition for shell companies and the definition should be extensive in nature so that legal entities that appear to be shell companies doesn't get affected unnecessarily. Regulatory authority should ensure that companies follow all the regulations effectively and the companies which default in following the regulations should be brought under the radar of the Regulatory authorities. The role of chartered accountants should be given more prominence and any strict action must be taken against Chartered accountants who gets involved in such illicit practices. A vigilance committee should be incorporated which should be required to give clearance certificate to all the companies which come within the radar of shell companies. The penalty for the using the shell company for illicit purpose should be made as a criminal offence and should be made liable for imprisonment.