

**ISSUES ARISING DUE TO LACK OF A LEGISLATION TO REGULATE SHELL
COMPANIES IN INDIA-A STUDY OF EVASION, MONEY-LAUNDERING AND TERRORISM**

***PURU ROHATGI**

INTRODUCTION

There have been several attempts at defining a shell company. On December 6, 2017, the Vice President of ICAI, Naveen N.D. Gupta, stated that ICAI's Central Council will now finalise a definition for "Shell Company". So as to incorporate the notion of shell companies, the CA institute has advised the Corporate Affairs Ministry to bring amendments to CARO (Companies Auditors Report Order)¹. As far as the concern for defining a shell company, in their paper of Global Shell Games², Michael Findley, Daniel Nielson and Jason Sharman have elicited them as in contrast to functioning or trading companies having workers who create products or deliver services, shell companies are little more than the legal identity that a company holds. Hence the name, "shell". Hence, such an entity can be explained as a non-trading vehicle which is kept dormant. However, the only difference between a dormant and a shell company is that the prior one gets its title in two ways: choice to get the 'dormant' status from the Registrar of Companies through an application, or if there is no filing of financial statements or annual returns for two financial years consecutively, the Registrar shall issue a notice and include it in the register of dormant companies. There is no business run by a shell company, and it exists without any noteworthy assets. It may be used for both legitimate, as well as illegitimate purposes. Given below are the three P's for a businessman or woman to use a shell company as legal tools to serve a number of advantages:

1. Protection – Business is always accompanied with risk. The factor of risk is directly proportional to the size of a firm. Larger the firm, greater is the matter of liability. Hence, instead of putting the firm's entire business at risk, most of such large firms would in reality be an arrangement of smaller shell companies, which would help reduce the risk factor of doing business.

¹ K.R. Srivats, *CA institute to take a crack at defining 'Shell Company'*, THE HINDU BUSLIN, December 6, 2017.

² Michael Findley, Daniel Nielson and Jason Sharman, Media Summary: *Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies*, Cambridge University Press (UK), 7 (2014)

2. Privacy – Most of the entrepreneurs today are worried if their business idea gets copied by some other businessman. Shell companies can also be used to house intellectual property. This can be explained by looking at the popular example of Bacardi (rum manufacturer). The Bacardi family wanted to keep their intellectual property safe from the consequences of the administrative disorder in Cuba. They hence housed this information in a shell company created by them in the Bahamas, which prevented that information from becoming the property of the government of their homeland, Cuba.
3. Practice – Not used frequently, shell companies are often used by the growing entrepreneurs to practice how to put a business together, as they do not generally require capital.

However, in spite of these essential uses, businessmen tend to take the wrong way and use such anonymous entities as a vehicle for money laundering, sanctions busting, tax evasion, major corruption, financing of terrorism and a wide variety of other financial crimes. The biggest issue that arises in such cases is to track down these shell companies, because of their anonymous identities. Businessmen tend to set most of their shell companies in tax havens³, which have been defined by the United States Public Interest Research Group (PIRG) as countries or jurisdictions with minimal or no taxes. The wealthy individuals tend to avoid paying taxes by setting up an offshore shell company in such regions. As per U.S. PIRG's study of 2017, small nations such as Bermuda and the Cayman Islands have become synonymous with tax havens. While, the top five tax havens which are used by the Fortune 500 Companies with subsidiaries are – Netherlands (50%), Singapore (42%), Hong Kong (41%), Luxembourg (37%) and Switzerland (36%)⁴.

ANALYSIS OF EXISTING LEGISLATIONS

In India, there are three main legislations that indirectly focus on the regulation of shell companies – Benami Transactions Amendment Act, 2016; Prevention of Money Laundering Act, 2002 and the Companies Act, 2013.

³ U.S. PIRG Education Fund and ITEP, Offshore Shell Games 2017, 5 (2017)

⁴ U.S. PIRG Education Fund and ITEP, Offshore Shell Games 2017, 15 (2017)

BENAMI TRANSACTIONS AMENDMENT ACT, 2016

This act amends the 1988 Benami Transactions (Prohibition) Act which forbids Benami transactions and the right to recover property held Benami and for issues corrected therewith or supplementary thereto⁵. The act is effective in washing off and unearthing black money from India. To achieve this goal, the income tax officer along with the assessing officers collect and send information of Benami properties and transactions. The article by Advocate Paras Kochar lays main emphasis on all such transactions in which the real beneficiary of a property is a ‘mere front’ for the actual beneficiary. This statement explains the meaning of a Benami Property as defined under the Act⁶. The benami property of Satyendra Jain (AAP Minister) and of the family members of Lalu Prasad Yadav was confiscated by the Income Tax department. When the case was taken up to the Delhi High Court, the petitioners contended that the Income Tax department’s claim that Lalu’s kin are the end beneficiaries of these properties is incorrect⁷. However, the amended act of 2016 mentions that the end beneficiary is to be held responsible for a penalty and imprisonment upto seven years.

THE COMPANIES ACT, 2013

Often, there arises confusion in between a dormant and a shell company. A dormant company gets its title in two ways: choice to get the ‘dormant’ status from the Registrar of Companies via an application, or if there is no filing of financial statements or annual returns for two fiscal years consecutively, the Registrar shall issue a notice and include it in the register of dormant companies⁸. Further, section 164 of the Companies Act, 2013 provides the grounds for disqualification for the appointment of the director of a company, where under section 164(2)(a) if a company (public or private) has not filed its financial statements or annual returns for any uninterrupted period of three fiscal years⁹. However, no such disqualification shall take place if such period as mentioned above is less than three years. Hence, another distinction between a shell and a dormant company is based on the disqualification of the directors. A dormant company’s director will not be disqualified on the grounds of section 164(2)(a). As of September 20, 2017, the government had identified over a hundred thousand directors of companies that did

⁵ The Benami Transactions (Prohibition) Act, 1988, No. 45, Acts of Parliament, 1988 (India).

⁶ Paras Kochar, *Benami Property and Transactions – A Brief Analysis*.

⁷ Atie Jain, *Lalu family members to contest Benami proceedings in Delhi High Court*, IND TOD, July 3, 2017.

⁸ Section 455, The Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).

⁹ Section 164(2)(a), The Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).

not file their statements for three continuous years¹⁰. The striking off of the names of such companies can be done by two ways:

- Strike off by the RoC (Registrar of Company) under section 248(1)(c) of the act.
- Voluntary strike off.

PREVENTION OF MONEY LAUNDERING ACT, 2002

Under this act, money laundering has been defined under section 3 as someone's indulgence or involvement (directly or indirectly, partly or wholly) in any process connected with the proceeds of crime, which includes its concealment, possession, acquisition or use and projection or claiming of it as unattained property¹¹. The object of this act is to prevent money laundering, and seize the property involved in such activity. The punishment that is given to the offender is a rigorous imprisonment for a term more than or equal to three years, which shall extend to seven years, along with fine, as provided under section 4 of the act. However, no specific provision has been provided in the act which explicitly addresses shell companies as such.

MULTI-CRORE FRAUDS: VIJAY MALLYA AND NIRAV MODI

Amongst the legitimate uses of a shell company, the main use is that of protection from risk. The risk factor that a firm might face is greater if the size of the firm is big. Thence providing an appropriate reasoning of such scams that have been happening since the Harshad Mehta scandal.

Vijay Mallya was born with a golden plate. He inherited his father, Vittal Mallya's empire of United Breweries Group, an Indian conglomerate with interests including real estate, aviation, beverage alcohol and fertilizer. He currently lives in the UK and is wanted in India on the charges of money laundering and fraud of Rs. 9000 crore. As per the Enforcement Directorate (ED) officials, Mallya formed twenty shell companies in India besides twelve more overseas to set the funds upraised as loans to run the disturbed Kingfisher Airlines. A large part of Rs. 6900 crore which was raised by him from IDBI Bank was via these shell companies. As per the

¹⁰ Shakti Patra, *Shell companies: Govt may have applied Companies Act retrospectively to bar directors*, LIV MIN, September 20, 2017.

¹¹ Section 3, Prevention of Money Laundering Act, 2002, No. 18, Acts of Parliament, 2002 (India)

complaint filed by the Serious Fraud Investigation Office (SFIO), there was an issuance of an arrest warrant against 19 people in the Kingfisher Airlines case, Mallya being one of them.

The billionaire jeweller from Gujarat, Nirav Modi has also become a centre part of the Rs. 13,400 crore Punjab National Bank fraud. The allegations against him marked the beginning of the fall of his diamond empire. The ED has explored 120 shell companies that have been allegedly linked to him. The two companies involved in this scam are the Nirav Modi Jewellers and the Geetanjali Group. As per the investigation¹², around forty companies were registered at one particular address in Bandra East, Mumbai.

WORKING OF SHELL COMPANIES

Money laundering and tax evasion are the two most sought issues for which a shell company is incorporated these days. Absence of a legislation concerned exclusively with the regulation of shell companies work as an instigating factor for businessmen to create more of such companies to evade taxes and launder money. Essentially, there are three steps involved in money laundering:

- By the ways of fake banks, currency smuggling, blending illegal funds with legal funds, etc. a person moves his cash from its original source into the circulation.
- So as to make it problematic for agencies to detect and uncover any laundering activity, the second step of layering comes into place. This is done mainly through conversion of cash into monetary instruments by ways such as money orders.
- Finally, to make the laundered money appear as a normal business earning, methods such as false import/export bills, shell companies, benami properties, etc. are used to allow the movement of the laundered money into the economy majorly via the banking systems.

Now a shell company is set up usually by a large infrastructure company which is need for cash for various transactions. The company writes a cheque to the shell company and accounts for it as payment of commission. Once the shell company returns the money as cash, after taking a minor part of it, the white money gets converted to black money as the company has then

¹² IANS, *PNB fraud: ED probing 120 shell firms linked to Nirav Modi, Mehul Choksi*, BUS STAN, February 22, 2018.

obtained cash for various illicit payoffs, while being able to manage to account for it in its books. While, the shell company shows the taken income from the company as contractual income, instead of commission so as to avoid tax (GST). Now to avoid income tax on this earning, the shell company shows that payments are made to another shell company (say, X) towards the fulfilment of contracts. Hence, the money is routed to further shell companies who account for it as share capital. Here, there is no actual flow of money to these firms, they are all notional.

Now the task of the large infrastructure company is to convert the black money back to white money of the shell companies. This is done by selling off the shares of the company at huge discounted rates to the face value of those shares. This allows the buyer to gain control of a company whose assets are clean by paying a mere fraction of the cost in white. This buyer organises small cash payments via different banks into the accounts of the company, to bring in the black money into the company as white.

In this way, a shell company operator acts as an intermediary between two parties, one who wants to convert black money into white money and the other who wants the vice-versa.

FUNDING TERRORISM

Since the events of September 11, 2001, the political and legal responses to terrorism have changed unlike after any other such event in past. Even after more than ten years and a number of targeted military strikes, in spite of the increase in surveillance, the growth of terrorist organisations like the al-Qaeda, has not stopped. The crux of this type of growth of these organisations is their base of their funding. As put forth in her article¹³, Mehrsa Baradaran puts forth that the establishment of al-Qaeda's financing network was one of Osama's earliest and most important accomplishments. This fight has often been referred to as a "three trillion dollar war". Nations worldwide have spent over billions of dollars to combat this war of terrorism. For instance, the U.K. alone spends around three billion pounds per year to fight terrorism. The true lifeline of terrorism lies in its secret network of global financing. Shell companies allow the terrorist organisations to mask their individualities and transfer the funds covertly. And since there is often no way to trace such anonymous shell companies, it poses a puzzling problem for

¹³ Baradaran and Shima, *Funding Terror*, 162 UNIV OF PEN LAW REV 477, 480-483 (2014)

the law enforcement agencies to stop such illicit activities. The inadequacies of the already existing policies explains how despite of the domestic policies use of shell companies as a front for terrorism and other illicit activities is being endlessly supported.

Of the many processes that can be used by the terrorist organisations, money laundering is the most reliable method to avoid detection. This multi-layered process is used to hide the illegal sources of income which in turn throughout the process is made to appear as legitimate. Since 9/11, the fight against this three billion dollar war has continuously focused on money laundering¹⁴. Given below are the challenges that are being faced by the law enforcement agencies:

- The available methods for money laundering, such as casinos, wire transfers, trusts and charities, complicate the efforts of law agencies.
- Those who are involved in the laundering activities are technologically ahead of the law enforcement, which makes the techniques used for laundering more complex and well financed.
- Even though most of the nations have laws for prevention of money laundering activities, the countries with the less effective laws are indeed the hub for the money launderers to conduct their businesses. As a whole, there exists an inconsistency of laws to stop money laundering across different nations. India being a developing country is one such example, where in spite of the existence of the Prevention of Money Laundering Act, 2002 along with other such laws, no deterrence has been achieved even after the infamous scandal penalisations.

Millions of shell companies are formed in one year in the United States alone. These shell companies are often used as a backdoor to a nation's financial system. Terrorist organisations distance themselves from the actual formation of specific shell companies by using company formation agents. India has been under a number of attacks from the al-Qaeda. The events of November 26, 2008 in Mumbai created a havoc in both the society as well as the economy at large. Not just the Taj incident, but starting from country's one of the first terrorist bombings in 1993 in Mumbai, where over 250 fatalities and 713 injuries were recorded, till date, India has

¹⁴ Jackie Johnson, *Will It Make a Difference to the Global Anti-Money Laundering Movement?*, MONEY LAUNDERING CONTROL: SUMMER 2002 9, 10-11 (2001)

been a centre spot for terrorist attacks. In 1980, when the Mandai Massacre took place in Tripura, over 400 people died, which has been recorded as the oldest terrorist incident in India, with the highest number of fatalities. Our country has witnessed an increasing number of such attacks every year. As per the Global Terrorism Database, there has been nearly 7703¹⁵ terrorist attacks in the territory of India from 2007 to 2017. Hence, in such a nation where there is a rampant increase in the number of terrorist attacks every consecutive year, the main foundation of the formation of any plan related to such attacks, i.e. funding source, must be restricted.

FINANCIAL ACTION TASK FORCE AND OECD GUIDELINES FOR MONEY LAUNDERING: ANALYSIS

The FATF (Financial Action Task Force), headquartered at Paris and created in 1989 at the G7, is an inter-governmental organisation whose object is the growth and advancement of guidelines to fight money laundering and terrorist financing¹⁶. One of the main reasons for the rise of money laundering activities today is the upsurge of liberalisation, privatisation and globalisation scheme implementations. The FATF pursues to escalate the recognition of anti-money laundering principles throughout the globe. The main aim of this organisation is to combat the three trillion dollar war of terror, for which in 2001 it added a list of recommendations addressing the same. The guidelines are subject to amendments as the technological advancements take place every few years now. These guidelines were last updated in 2012 including the widespread use of weapons of mass destruction like the atom and nuclear bombs. Apart from that, the focus was also put on creation of transparency, accountability and better governance to reduce corruption. Since then, the guidelines haven't been amended. Witnessing the highest increment in the number of terrorist attacks in India since 2014, mere framing of guidelines on paper, that too in an out-of-country jurisdiction, does not practically reduce the terrorist activities or their funding per se.

¹⁵https://www.start.umd.edu/gtd/search/Results.aspx?chart=overtime&casualties_type=b&casualties_max=&start_yearonly=2007&end_yearonly=2017&ctp2=all&country=92&count=100

¹⁶ OECD, *Money Laundering Awareness Handbook for Tax Examiners and Tax Auditors* 10 (Centre for Tax Policy and Administration, FATF and OECD, 2009)

The next section of this paper shall deal with the recommendation of the need for a proper legislation for regulation of anonymous shell companies so as to prevent or abate the illicit activities of money laundering, tax evasion and terror financing.

NEED FOR A LEGISLATION

Beside the recommendations and guidelines as set forth by the Organisation for Economic Co-operation and Development (OECD), Centre for Tax Policy and Administration (CTPA) and the Financial Action Task Force (FATF), there is a dire need for an exclusive legislation or framework of regulations that prevents, controls or abates the use of anonymous shell companies, charities, trusts and other vehicles for illicit as well as illegal purposes such as money laundering, tax evasion and funding terrorism. Although the existing legislations as mentioned in this paper, the Benami Transactions Amendment Act, 2016, the Companies Act, 2013, and the Prevention of Money Laundering Act, 2002, provide the basic framework and penalties for activities like money laundering, no legislation or regulation in India explicitly and unambiguously explains the meaning of a shell company, and hence such companies were never regulated under any legislation per se. India is a developing economy with rampant rise of global economy and international trade due to the technological advancements. But such illicit activities always happen in such an economy because the technology used by the launderers, for instance, is far ahead and advanced than those used by the law makers. Our country needs to take not just one step at a time, but be ahead of the launderers by more than five steps so as to identify their plan of laundering, and hence take active steps to abate the same.