SHELL COMPANY- HINDRANCE IN NATION'S GROWTH

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Abstract : *Shell companies are not illegal intrinsically but large number of them gradually moves towards illegal activities as a vehicle for tax evasion or converting black money into white. In India Shell Companies are those that had not filed financial statements for three financial years, these companies are used by business companies to evade taxes, promoters use these companies for diverting funds from listed or unlisted companies and some of these shell companies exist only on papers and having only postal addresses with no real office or employees or backed up by actual assets or cash flow. This paper recapitulates the illicit activities that take place through shell companies, the effect of shell companies on stock market and investors. The paper also highlights the measures taken by the authoritative bodies and the suggestions to eliminate shell companies.*

I. INTRODUCTION

Shell company is described as a non-trading organization that does not engage in any active business operations or significant assets but exists only as medium for another organization's business activity. The corporate create or purchase shell companies to avoid taxes without attract legal action. It had not filed financial statements or annual returns for three consecutive years.
There are multiple reasons due to which a company becomes shell like; the company had operations in the past and has gone out of business owing to pure economic reasons or the company was registered but could not start operations because of some economic reason. Shell companies are not illegal intrinsically but large number of them gradually moves towards illegal activities as a vehicle for tax evasion or converting black money into white. All companies which are not producing the annual financial statements are not illegal as many are not engage in any production and trading.

"Securities Act Rule 405 and Exchange Act Rule 12b-2 enacted by USA define a Shell Company as a company, other than an asset-backed issuer, with no or nominal operations and either:

- No or nominal assets;
- Assets consisting of cash and cash equivalents; or
- Assets consisting of any amount of cash and cash equivalents and nominal other assets."

In India Shell Companies are those that had not filed financial statements for three financial years, used by business companies to evade taxes and use promoters for diverting funds from listed or unlisted companies and some of these shell companies exist only on papers and have no physical identity. These companies are incorporated by doing all formalities and get registered under registrar of companies, having only postal addresses with no real office or employees or backed up by actual assets or cash flow. The directors of such companies are again individuals who are mostly illiterate or semiliterate and work for the real operators for small salaries or commission, their paperwork was clean and they had been regular in filing their annual paperwork with the registrar with the help of auditor.

I.1 FUNCTIONING OF SHELL COMPANY

The shell company is created by the person that holds the unaccounted money to convert the illegally held money into legal wealth for which tax has not been paid and the source is accounted for.
After formation and listing of these companies the shares are sold to other businessmen, who are aware of the real motive behind the company, at the very high premium with some covert deal with them.
The companies who buy or sell through shell companies want to hide their actual profits for tax haven, transacting through these shell companies ensures that they need not to report their transactions.Some companies make their black or illegal money white or legal by paying to the shell company X amount through a cheque which would later be returned by the shell company in cash. Shell Company covers its tracts by showing payment to other smaller shell companies.

I.2 HOW ILLICIT ACTIVITIES TAKES PLACE IN SHELL COMPANIES

There are number of shell companies which are under government scanning due to their dubious activities. The major illicit activities performed by the owner of Shell Companies are:

1. **Selling shares at very high premium:** A common way to use the shell company to park the black money is to buy the shares of beneficiary company say by politician at very inflated market rate. For instance; in case of Jaganmohan Reddy the CBI found that large amount were channelled into his company by a group of investors by purchasing the shares of

the beneficiary's company at high premium which remain idle with the company and not been used for purchase of assets or put in some financial dealings.

2. **Layering:** Many on paper shell companies being opened and get registered with Registar of Companies and having bank account in same branch. The process of forwarding entries in the beneficiaries companies is done by 'layering' the cheques i.e. cheques were routed through many paper/dummy companies before reaching its destination the beneficiaries. Money is transferred from A company to Z company through multiple transaction A pays B, B pay C... W pays to X and so on till Z gets the money. This is done by way of simultaneous clearance cheques drawn by one company favouring other through a series of credit/debit entries to deceive the government. For instance in Madhu koda case, investigators found that his accountant had layered payments through over 200 companies.
3. **Loan to Shell Company:** the beneficiary's company can accept loan from some other companies or individuals, these loans are never being paid back by the beneficiary's company as well as the amount of loan would not be invested for business purpose or in developing of business assets. For instance; a large amount of money given by one of the licence winner to Kalagnar TV in the form of the loan, which need to be paid back but no repayment has been made.
4. **Floating of on-paper company:** in this the hundreds of on paper companies are incorporated and get registered under Registrar of Companies. The purpose of floating these companies was to meet the demand of those beneficiaries who wanted to buy some readymade companies. These companies were sold to different beneficiaries as commodity for a lump sum amount. For instance; According to excerpts of the report on the 2004 search, which were quoted as part of an Income Tax Appellate Tribunal (ITAT) order, "Mr Ruia took up activity in the eighties and by now he has floated hundreds of companies.

I.3 PROBLEMS DUE TO SHELL COMPANIES

The existence and operation of shell companies has become the matter of concern for every country as these companies indulge in:

1. tool for tax avoidance
2. aid money laundering for terrorist activities
3. converting black money into white

To restrain this issue an international, inter-governmental body was formed in 1989 for "combating money laundering, terrorist financing and other related threats to the integrity of the international financial system". Known as the Financial Action Task Force (FATF), it has 180 members with India also being a part of it. The FATF has laid down rules and processes to deal with the menace created by such companies.

II. STATE AND LAWS FOR SHELL COMPANY: STORY SO FAR

In the year 2017, 331 companies, which may be shell, were banned from trading in NSE and BSE as per the order by SEBI. In extension to that 48 companies and 162 companies of NSE and BSE respectively moved into Stage-VI of the Graded Surveillance Measure (GSM) which means that those stocks would not be available for active trading.

According to the Ministry of Corporate Affairs, there were around 2.09 lakh shell companies, of the total 10.2 lakh companies registered with Registrar of Companies (RoC), for not filing the financial statement for the immediate two preceding financial years. To stop the mushrooming of Shell Companies and protecting the investors interest the Registrar of Companies (RoC) cancelled the registration of nearly 2,09,032 companies for violation of section 164(2)(a) of the Companies Act (2013) i.e. failed to file their annual financial returns. The following table shows the percentage of shell companies in each Industry as compared to the total number of listed entities in the respective Industry.

Industry Section as per NIC 2004 Classifications	Total of Listed Companies	Shell Companies as per SEBI	Percentage of Shell Companies as per SEBI
Manufacturing	3791	88	2.32
Financial Intermediation	1531	83	**5.42**
Wholesale and Retail Trade; Repair of Motor Vehicles; Motorcycles and Personal and Household Goods	982	55	**5.6**
Real Estate; Renting and Business Activities	1289	52	4.03
Construction	293	18	**6.14**
Agriculture; Hunting and Forestry	275	9	3.27
Other Community; Social and Personal Service Activities	134	7	**5.22**
Mining and Quarrying	105	5	4.76
Extra Territorial Organisations and Bodies	281	4	1.42
Transport; Strong and Communications	161	4	2.48
Electricity; Gas and Water Supply	96	2	2.08

Hotels and Restaurants	80	2	2.5
Education	15	1	**6.67**
Health and Social Work	124	1	0.81
Fishing	40	0	0
Public Adminstration and Defence; Compulsory Social Security	2	0	0
Undifferentiated Production Activities of Private Households and Activities of Private Households as Employers	4	0	0
Total	**9203**	**331**	**3.6**

(Analysed and published by InstaFinancials)

As per the table the manufacturing industry has maximum number of shell companies followed by financial intermediation 83, wholesale and retail trade 55 and real estate 52 shell companies.

Director Disqualification by Ministry of Corporate Affair:

On September 2017 The Ministry of Corporate Affairs has brought a list of 1,06,578 disqualified directors those have association with of shell companies that have failed to file financial statements and/or annual returns for a continuous period of three financial years.

DIRECTOR CUT

A number of directors of shell companies were identified or disqualified in government exercise. The top 5 region-wise:

Region	Directors in Struck-0ff Companies	Region	Disqualified Directors
Chennai	24,048	Delhi	74,920
Ahmedabad	12,692	Mumbai	66,851
Ernakulam	12,000	Hyderabad	41,156
Cuttack	4,760	Ernakulam	14,000
Shillong	670	Cuttack	13,383

As per the table the maximum number of disqualified directors are from Delhi (74,920) followed by Mumbai (66,851) and Hyderabad (41,156) and so on. The directors whose names are there in list of disqualification are barred from being appointed as directors in other companies for a period of five years. The government instructed banks to ensure that the disqualified directors are restricted from operating the bank accounts of the companies that were struck off. The Ministry of Corporate Affairs declared that other professionals like chartered accountants, company secretaries and cost and works accountants will also be penalized for being part of shell companies.

In February 2017 a task force, was set up under the joint Chairmanship of the Revenue Secretary and Corporate Affairs Secretary, consists of committee drawn from the Department of Financial Services, the RBI, and various law enforcement and regulatory bodies is set up to check the menace of 'shell companies' indulging in illegal activities, including tax evasion. The task force's major achievement is that they have made a database of 80,670 suspected shell companies drawn up by the SFIO (Serious Fraud Investigation Office) using 'Red Flag Indicators.

The database has three lists:

1. The Confirmed List: has 16,537 confirmed shell companies on the basis of the information received from various law enforcement agencies.
2. The Derived List: List has 16,739 companies identified on the basis of 100 per cent common directorships with the confirmed shell companies.
3. The Suspect List: have 80,670 suspected shell companies.

III. SHELL COMPANY HOW IT EFFECT THE STOCK MARKET

The listed shell company in stock exchange sold the shares at premium to other businessmen or investors who are aware of the true reason behind the start of the company and shell company provide some hidden benefits to these investors. Due to abnormal price rise in the shares of shell companies the common investors also get attracted towards the company and buy its shares. As per Abhimanyu Sofat, Vice President, head of research, IIFL "Sometimes a lot of retail investors were wrongly being advised or lured into investing into penny stocks or companies which may not have any genuine business operations. In the past many investors had suffered with the loss as many companies that were listed during the IPO boom in 1994-95 have suddenly vanished without a trace."

In December 2014 market regulator SEBI stopped trading of around 300 stocks accusing them as shell companies being set up to evade income tax. There were several individuals with shares of shell companies incur losses as trading in these stocks had dried up.

In August 2017, 36 lakh stock investors, including Rakesh Jhunjhunwala and some of the top mutual funds like DSP Blackrock, HDFC Mutual, Reliance Mutual and UTI Mutual Fund have exposure to these stocks as do foreign institutional investors such as

Goldman Sachs, Fidelity, Blackrock and Smallcap World incur a huge loss to investors by fall in the market price of the shares with SEBI restriction on trading on some 331 stocks of suspected shell companies.
The Securities and Exchange Board of India (SEBI) directed to Bombay Stock Exchange (BSE), the National Stock Exchange (NSE) and the Metropolitan Stock Exchange to place these companies under the Graded Surveillance Measure (GSM). If any listed company out of the said list is already identified under any stage of GSM, it shall also be moved to GSM Stage VI directly.

IV. SHELL COMPANIES- CASES

CASE I: A case of shell company named Ganga Builders floated in 1982. On February 14, 2008, 18 companies based in Delhi, Mumbai, Guwahati but predominantly in Kolkata invested Rs 10 crore in a company called Ganga Builders
On the exact same day that this transaction happened, another much bigger one took place -- one which was to eventually catch the eye of a range of investigative agencies including the Central Bureau of Investigation (CBI) and the Income Tax Department.
Seventeen companies, many of them belonging to well-known industrial groups, injected a total of Rs 121.24 crore into Jagathi Publications, the flagship media company owned by Jagan Reddy. Ultimately, according to news reports, the CBI would go on to investigate a total of over Rs 1,100 crore worth of investments into Jagathi over a period of years. Among those Valentine’s Day investors into Jagathi in 2008 were a smaller clutch of Kolkata and Mumbai-based firms and this is where their paths cross with Ganga Builders. For many of the investors into Ganga, and many of the investors in Jagathi, were common. Income tax investigators visited Ganga’s address, situated in an office complex in a commercial area in the heart of Kolkata. It was an address that the company shared with a few other paper companies who had invested in Ganga. All they found was a single office with a peon who confirmed that the companies indeed operated from there, but could give no other details about its owners.

CASE II: The income tax (IT) department in Kolkata launched a probe into the operations of Anjali Jewellers Pvt. Ltd, a 25-year-old family owned enterprise, now a leading jewellery-maker in West Bengal. After closely tracking Anjali for years, it appeared that the company was expanding much faster than what its declared cash flow would permit, there was some cash flow going into asset creation that the returns did not reflect. Anjali was struggling to reconcile its inventory with its books of accounts—there was more gold and jewellery lying in its stock than recorded in its books. When the ledger of company investigated by tax department it was found that the transactions were “bogus transactions”, shown in Anjali’s accounts to suppress profits. The department claimed Anjali had concealed at least Rs160 crore of income. After a few days of resistance, the company agreed to settle, admitting a tax liability of around Rs70 crore.

CASE III: During the investigation by the Enforcement Directorate (ED) in the Punjab National Bank (PNB) fraud case, the agency has found that Nirav Modi laundered Rs 5,921 crore in 2017 using 17 shell companies based out of the country. In India Nirav Modi used his firms - Diamond R US, Stellar Diamond and Solar Exports - and received Rs 6,498 crore through 150 fraudulent LoUs that were issued between February 2017 and May 2017.The money was withdrawn from the overseas branches whose officials were recently questioned by the Central Bureau of Investigation (CBI)."Two close confidant of Nirav Modi - Karthik Doshi and Shyam Sundar Wadhwa - were aware of the entire fraud and helped Nirav Modi in this money laundering. Wadhwa helped in creating two dummy companies, namely, Sino Trader and Aruna Gems Limited, floated abroad and made Karthik Doshi and two others dummy directors/public shareholders by getting them to sign the relevant papers. The Directorate of Enforcement (ED) has analyzed in March 2018 that jewellery designer Nirav Modi and Mehul Choksi used 120 shell companies in the Punjab National Bank (PNB) fraud case. These companies and trusts have been used by Modi and Choksi to divert the money taken from banks. Nirav Modi laundered Rs 5,921 crore in 2017 using 17 shell companies based out of the country. In India Nirav Modi used his firms - Diamond R US, Stellar Diamond and Solar Exports - and received Rs 6,498 crore through 150 fraudulent LoUs that were issued between February 2017 and May 2017.

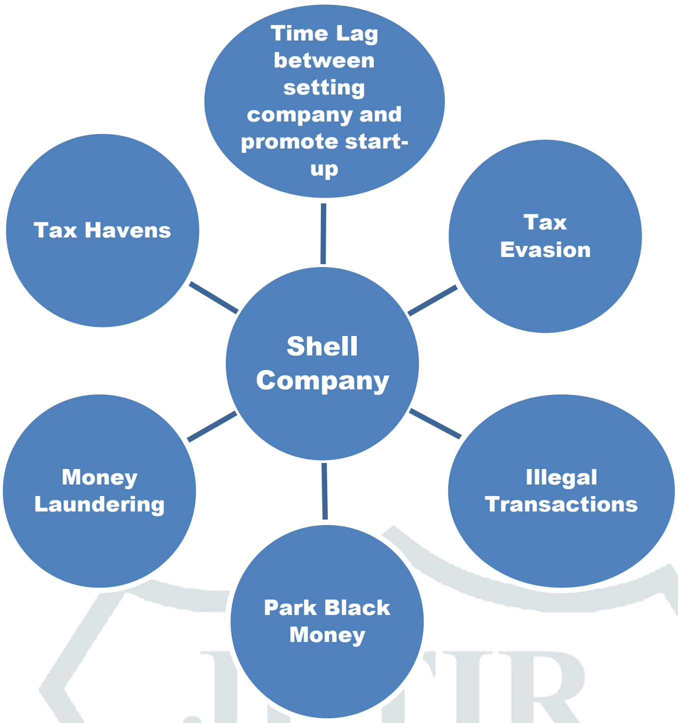
IV. METHODOLOGY OF THE STUDY

In the process of completing this study, the researcher has referred to several credible sources of data including reports published by various government and non-government agencies to understand and evaluate the problems accrued due to Shell Companies and the measures taken by the government to deal with the destruction done by those companies.

V. OBJECTIVES OF THE STUDY

- To comprehend the various attributes of shell companies
- To understand the problems faced due to shell companies
- To understand the Security and Exchange Board of India measures to discourage shell company
- To suggest the ways to discourage shell companies

A. The various attributes of Shell Companies are:
The Shell Company are often created by big corporate to avoid taxes without attracting legal actions. The various features which help in comprehending Shell Company are:



Money Laundering:
A commonly cited maltreatment of the shell corporation model is money laundering. When money is obtained through an illegal means, it is critically important that there are significant buffers to prevent the funds from discovery. A shell corporation is ideal for this purpose. By obscuring both the ownership of the shell corporation and its activities, it is relatively simple to conceal the true origin and intent of large amounts of funds.

Tax Havens:
A tax haven is any investment that shelters income from taxes. In this the proprietor or investors invests money in the regions with relatively low tax. It would be saving in long term as those taxes are considerably lower than what the company would pay on that actual income.
Time lag in setting the company and promote start–up:
When the company had operations in the past and has gone out of business owing to purely economic reasons or the company was registered but could not start operations because of some economic reason.
Tax Evasion:
Tax evasion is the under payment or non payment of tax. Tax evasion is the difference between the amount of income that should be reported to the tax authorities and the actual amount reported. The Shell companies are used to transfer assets from the existing profitable company to its new establishment, while leaving the liabilities in the former company this help the company to evade tax.
Illegal Transactions:
After formation and listing of shell companies their shares are sold to other businessmen, who are aware of the real motive behind the company, at the very high premium with some covert deal with them. Many times companies indulge in the process of forwarding entries to the beneficiaries by 'layering' the cheques.
Park Black Money:
Some companies make their black or illegal money white or legal by paying to the shell company X amount through a cheque which would later be returned by the shell company in cash to the former ones.

B. **To understand the problems faced due to shell companies**
The Shell Companies create problems to the banks, stock markets, investors and economy of the country.
Problem to investors
Investors invest their hard earned money in companies with the objective to get the return as per market. Sometimes a lot of retail investors were wrongly being advised or lured for investing into penny stocks or companies which may not have any genuine business operations. In the past many investors had suffered with the loss as many companies that were listed during the IPO boom in 1994-95 have suddenly vanished without a trace. Some shell companies take the advantage of investors' expectations to earn higher return and lure them by promising unusual returns on their investment. Recently West Bengal, India was rocked by a chit fund scam where a company by the name of Saradha Group duped a lot of investors with a promise of unusually high returns. The group tricked mostly small investor and siphoned of almost 17000 crores approximately. As per an estimate there are almost 60 such registered or unregistered firms operational in Bengal alone. Due to directive to stock exchanges for action against 331 companies the trading of shell companies shares got banned and investors incurred a huge loss by fall in the market price of the shares and over ₹7,000 crore of public money stuck in them which hardly going to move up in future.

Problem to stock markets

The shell companies undergo trading on the exchange platform allegedly without having actual possession of the commodities and due to excessive transactions of shares in the market take the share market prices shoot to abnormal range. Various companies' takeovers shell companies to turn black money into white. The share of these shell companies are bought at huge discount, say at Re 1 per share, while the book value is Rs 50 per share. The SEBI has to initiate a process of verifying the credentials / fundamentals of such companies and appoint an independent auditor to conduct audit of them. They may even conduct a forensic audit of these companies to verify its credentials/fundamentals.

Problem to banks

The Shell companies divert loan funds issued by bank for some alleged purpose by creating fake invoices, and "round-tripping" of funds to evade taxes and generate black money. In 2017 the CBI probe into various loan fraud cases and various murky activities have been exposed and about 200 bank fraud cases involving funds of at least Rs 30,000 crore. As per CBI over 98 shell companies allegedly divert bank loans for setting up digital studios in Noida, Mumbai, Kolkata and other locations.

Embezzling through Shell

Accused Companies	Total Bank Fraud (in Crores)	No of Shell Companies	Diversion of Funds through Shell Coies (in Crores)
Century Communication, Noida	3000	98	802
Zoom Developers, Mumbai	2600	6	460
FLCIL, Mumbai	748	15	under investigation
NSEL, Mumbai	342	9	342
Showman Group, Mumbai	245	23	20.5
Bengal India Global Infrastructure, W. Bengal	187	1	108.55
JNPT, Mumbai	180	26	428
Maheshwary Ispat Ltd, W. Bengal	179.85	1	100.85
RP Infosystems Limited, W. Bengal	138	1	2.6
SPS Steel Rolling Mills, W. Bemgal	100	3	98
HRM Pvt. Limited, Jind	29.94	21	20

Figures and names as alleged by the CBI in its charge sheets and FIR

The above mentioned are various accused companies those were allegedly used to divert funds towards shell companies. The CBI has unearthed complex webs of 393 shell companies involving diversion of fund to the tune of 2900 crore during its probe in banking fraud cases in last 3 years The banks as per the orders of government and RBI have to freeze the respective accounts and no deposits or withdrawals are allowed as well as the money of these shell company accounts is not considered in the bank's corpus.

Problem to economy

The Real estate worked as intermediaries- broker who helps turn black into white. According to the report of ET Magazine, infrastructure companies, which need large amounts of cash to pay off bribes to everybody from local politicians to naxalites, are the ones that mostly enter into such deals. They sign a cheque to one such shell company, and this is accounted as payment or commission. This company returns the money in cash, which the infra company uses to pay bribes.

C. To understand the Security and Exchange Board of India measures to discourage Shell Company

With the intention to identify and protect investors from dealing in shell companies's shares at an early stage Security and Exchange Board India has designed the Graded Surveillance Measure (GSM). It keeps a check on shares which see an abnormal price rise not commensurate with the financial health or fundamentals. The companies which come under surveillance are often illiquid, have low market capitalisations and poor fundamentals. These companies are being bid up and used for money laundering. The regulator monitored for sudden changes in earnings, book value, fixed assets, net worth, and price to earnings multiples, among other factors.

As the company is identified as shell it goes in to one of the six stages of the GSM where the restrictions on trading in the securities get progressively higher:

1. Stage I: Securities are placed under the trade-to-trade category, and a maximum of 5 per cent price movement in shares is allowed.

2. Stage II: In this stage not only a 5 per cent price band for shares movement is prescribed but also attracts an ASD of 100 per cent. Additional Surveillance Deposit (ASD) is applicable for trading in these shares. The ASD will be retained by the exchange for a period of 5 months.

3. Stage III: Apart from paying an ASD of 100 per cent on the traded value and buyers are allowed to trade in the security only once a week, i.e every Monday.

4. Stage IV: Attracts an ASD of 200 per cent on the traded value.

5. Stage V: In addition to an ASD of 200 per cent the trading is permitted only on the first Monday of a month.

6. Stage VI: In this stage attracts far higher restrictions i.e. trading in these shares are permitted only once a month, that is on the first Monday of the month without any upward movement in price.

The SEBI review of the shares of companies under GSM took place twice a year and then the shares are moved out of or remain in GSM. Also, a quarterly review of GSM stages will be done where qualified companies may be moved back from a higher to lower stage. The companies put under GSM can challenge SEBI for relief in the Securities Appellate Tribunal (SAT) or the high courts. The SAT stayed the SEBI directive against company and the exchanges remove the trading restrictions against it.
Now as per the Section 248 of the Companies Act: "Registrar of Companies has powers to remove name of a company from register of companies where a 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."
All these initiatives help the government and SEBI to keep check on the initiation of the shell companies towards illegal activities as a vehicle for tax evasion or converting black money into white.

D. To suggest the ways to discourage shell companies
Proper scrutiny by Registrar of Company: the RoC at the time of registering the company need to check all the documents filed by the companies as well as sends the officers to check whether the company is physically present with proper set up or it's only on paper. The RoC should also meet the directors of the company to see whether the directors are really capable to make decision related to the company or they being shown on paper only for namesake.
Proper check by Bank before sanctioning of loan: when the banks need to finance the company it is very important to see the past history of proprietor and the company. If the company has taken loan from some other banks the NOC of other banks need to be submitted. The liaising officer can visit the company to confirm its process and to see whether the proposal of finance submitted by the company is as per the actual requirement.
Proper awareness to investors: the awareness about Shell Company among the investors can be increased by SEBI to keep them protected by the frauds. The investors can be advised go through the financial statements and annual returns of the company before investing in any company. The investors need to be beware of sudden and unusual fluctuation in share price of any company without any technical and fundamental reasons changes in the company.
Legal action against companies not filling financial statements or annual returns annually: it's very important to strictly follow the section 164(2)(a) of the Companies Act (2013) i.e. failed to file their annual financial returns. If any company fail to file the annual return the registration of the company can be cancelled immediately.
Conclusion:
There are multiple reasons due to which a company becomes shell like; the company had operations in the past and has gone out of business owing to pure economic reasons or the company was registered but could not start operations because of some economic reason. Whatever the reason to be Shell but the price have to be paid by the investors as they bare loss when the shell companies suffered suddenly vanished without a trace. These companies misguide banks which are backbone of any economy and use the issued funds for some alleged purposes and embezzled the money which become very tough for bank to get back. It's very important that there should be cooperation among government, SEBI and RBI to wipe off shell companies. This will help providing secured platform to the investors to invest and earn, the economy will also develop when the money issued by the banks are used by registered for the development of various sectors of the economy and last but not the least the government can get corporate tax to plough back in the economic development.

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VII. LINKS

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