

# Cracking the Shell: Clandestine Vehicles for Money Laundering and Tax Evasion



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Shell companies are legal entities without any tangible assets or business operations and usually have a low paid-up capital. They are used as a corporate vehicle for various purposes like raising funds for pre-operations, taking control over other firms or corporatize a business as a prologue to public offering.<sup>1</sup> A report by OECD, however, asserts that they are increasingly being used for illicit purposes.<sup>2</sup> They have become a vehicle for carrying out complex corrupt transactions, money laundering and tax evasion.<sup>3</sup>

Shell companies that cannot be traced back to their real owners are one of the most preferred means for committing financial crimes. They pose serious threat to economy as money launders commonly use them for conversion of black money. A report by

Global Financial Integrity estimated that India suffered \$344 billion in illicit fund outflows between 2002 and 2011 through such companies. In this article, we present the modus operandi of shell companies, the challenges they pose and how to deal with them.

## Shell Companies: A Clandestine Vehicle

Shell companies, in essence, merely exist on paper and are used as a vehicle for another company's business. They may profess to have employees, registered office and a telephone number but a closer eyeball makes everything discernible. They provide a means to their real owners to retain anonymity while guaranteeing total control. The perpetrator floats a number of companies usually with the same registered address and with directors who despite being 'real persons' are untraceable or completely un-related or are usually poor and unlettered lending their names for a token payment. Nominee (or dummy) directors are used for anonymity or deniability, who pre-sign cheques and documents and hand them over to the principals.

As per the report of the Special Investigation Team (SIT) on black money which looked into the activities of shell companies<sup>4</sup>, 345 addresses had at least 20 companies operating from the same place. Also, 13,581 companies were sharing their address with at least 19 other companies. SIT report also said 2,627 persons were directors on the board of over 20 companies in violation of law. As many as 77,696 companies violated norms of directorship as provided in section of 275 of the old Companies Act of 1956.<sup>5</sup> Such gross violations suggest use of dummies for the purpose of shell companies.

Shell companies may be incorporated in any jurisdiction and offshore financial centres (OFC) but those offering strong confidentiality and lack of transparency become the obvious choice. OFCs typically have zero/low taxes, fast company incorporation, offer USD accounts, do not put any restrictions on transfer of funds or profits and also offer bearer share companies and trust structures. Their AML laws are either not stringent or not enforced. Specifically, their company and trust formation agents may not be required to be registered (with "fit and proper" requirements). Hence requirements for checking for beneficial ownership at company/trust formation may not be inscribed into law.

The shell companies are often incorporated under the International Business Companies (IBC) Act of the offshore financial center (OFC) which typically allows them to conduct their business solely with non-residents and they do not have any physical presence in the country. These shell companies established in offshore centres are operated by Nominee Director (agents) who often hide identity of real owners.

A maze of shell companies at onshore and offshore centres with non-traceability of real ownership is a big challenge for any country to deal dealing with the menace of money laundering and black economy.

## **Shell Companies - Operating Mechanisms**

### ***Money Laundering***

Money laundering is a criminal offence aimed at presenting wealth of illicit origin or the portion of wealth that has been illegally acquired or concealed from the purview of tax and other authorities, as legitimate, through the use of methods that obscure the identity of the ultimate beneficiary and the source of the ill-gotten profits.<sup>6</sup>

The process of laundering money may occur in a variety of ways, such as with the shrewd exploitation of a complex, interweaving web of secrecy jurisdictions and/or tax havens, the manipulation of the concept of legal persons and legal arrangements to concoct 'shell companies' that can operate as covers for corrupt individuals, the abuse of loopholes in existing anti-money laundering legislation.

Shell companies are an integral part of the money laundering process. For example, a person may set up a "false" business by obtaining the necessary and proper documents to open a bank account in the business name in offshore business centres of tax heavens. The dirty money is then put into the bank account, making it seem as though it was obtained legitimately. Intermediaries often assist in the formation process shell companies and act as directors or managers to hide details of real owners of companies.

Assets are difficult to trace to real owners because of layering of shell companies which covers up entire money trail. Money launderers through complex webs of shell companies draw their money back to country from tax heavens in a circuitous way (round tripping). Most of black money is rotated bank through bank account wire transfers. Often their suspicious transactions are below the threshold of automatic banking software triggers, and so difficult to detect.

Participatory Note (PN), a derivative instrument issued in foreign jurisdictions, is also considered a popular tool for re-routing black money to India hidden in offshore shell companies. These instruments are traded overseas outside the direct purview of SEBI surveillance, thereby, raising apprehensions about the beneficial ownership and the nature of funds invested in these instruments. SIT report on black money feels that PNs are used by shell companies located outside and entering country under the disguise of FII investment.

The recent leaking of offshore financial records from a Panama-based law firm again brings into focus the labyrinth of global networks of shell companies operating from tax havens, used purportedly to shift illegally assets and cash from one country to another and using structured transactions to evade tax. SIT observed that investments from the Cayman Islands, a tax haven, alone amount to Rs 85,000 crore in India.

### ***Securities Market Manipulation***

Shell companies are often used as a tool for securities market dealings for tax evasion and laundering of back money. The objective is to get exemption on long term capital gains and show the source of income as legitimate (from the stock market). The modus-operandi involves issuance of the shares by companies, often shell companies with very low fundamentals, on preferential basis to certain connected entities. Many times brokers also act as intermediary where they take cash from tax evaders and then route it through several accounts for executing the trade. Share price is significantly pushed to higher levels without any fundamental move, through circular trading among group companies. After one year of lock in, preferential shares are converted, giving an exit route to these investors and the shares would be sold back to the company or related entities raking in huge profits for tax evaders.

SEBI has, in its investigation of various cases, found preferential allotment as a major route for laundering illicit funds, where shell companies were in the epicenter of garnering huge long term capital gains. These shell companies did not exist on the addresses mentioned in their regulatory filings. In just two cases in which SEBI passed interim orders, total illicit gains were estimated to be Rs 500 crore. It has debarred 250 entities from securities market for their involvement in such frauds.<sup>7</sup>

### ***Trade Base Money Laundering***

Trade base mispricing is one of the common mechanisms to siphon off black money from the country. In this case, large foreign exchange remittances are sent overseas toward fictional imports of stocks and machinery, advances, commissions etc. All the imports are carried out under an umbrella of shell entity. A related shell company is also established outside India for carrying out the trade at extremely inflated prices.

Once black money is moved out of country, it is again transferred from overseas account of a shell company into another set of shell companies located in other countries. Often such money comes back to India through another bank account as receipts from exports. Real estate is another sector where such shells hold properties or land on behalf of the real owners or hold payments for fictitious sale of goods or services in India till the money gets 'bleached white'.

The SIT on black money recognizes mispricing of import/ exports as one of the significant mechanism for money laundering. In a recent case, CBI in December 2015 found fake foreign exchange remittances aggregating to Rs 6,000 crore made up from non-existent imports through various accounts of 60 companies, all of them operating from a single branch of a bank and controlled by a group of individuals masterminding the fraud.

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### **Billing Schemes**

Shell companies are involved in billing schemes, a form of occupational fraud. Or simply put, manipulation of expenses. Since the income on which taxes are payable is arrived at after deducting the expenses of the business from the receipts, manipulation of expenses is a commonly adopted method of tax evasion and used for money laundering. It involves inflation of expenses by obtaining bogus or inflated invoices from the so called 'bill masters', who make bogus vouchers and charge nominal commission for this facility. This is largely done through shell companies who operate shell entities in the form of proprietorship firms, partnership firms, companies, and trusts, and sometimes involve 'hawala' operators. These operators may accept cheques for payments claimed as expense and return cash after charging some commission.<sup>8</sup>

SIT report on black money found rampant use of shell companies for tweaking entries in books of account to covert black money into white.

### **Misuse of Exemption in Agricultural Income**

Another route of introducing black money into the banking system is by showing large incomes from agriculture, processing and milling of agriculture products and crop sales. All this is for the purpose of evasion of tax as agricultural income is outside the ambit of income tax and other tax nets.

Small companies with very small land holdings have been found to have showed agricultural income in tens of crores of rupees. Their output would be many times more than the district's output or the total annual sales in the local "mandi".<sup>9</sup>

### **Way Forward**

The prevalent use of shell companies poses serious threat to economy by providing shadow economy a parallel place. Vulnerabilities related to the use of shell companies become more reprehensible considering their increasing use for terror financing. Such shell companies need to be dealt on priority.

Any strategy to be effective against shell companies would involve two essential steps –timely identification of such companies to be able to intervene in time and a tight vigil over the operations of suspected shell companies.

For identifying domestic shell companies, MCA 21, the portal in which all corporate filings reside, is a wonderful starting point. The information could be used for tracking and mining data for companies sharing common characteristics like common directors, same registered address, little or no business, occasional large transaction etc. to create early warnings against the shell companies.

Enforcement agencies like Serious Fraud Investigation Office (SFIO) may prepare a set of red flag indicators with the help and active involvement of other agencies like Central Board of Direct Taxes (CBDT) and Financial Intelligence Unit (FIU). These agencies may then develop a mechanism to share information on a regular basis and mount closer surveillance on shell companies.

Untraceable shell companies are the most important means of providing financial secrecy. Enforcement agencies must be able to look through the corporate veil to find the real individuals in control of shell companies. Further, Section 89(1) and 89(2) of the Companies Act, 2013 requires persons to disclose their "beneficial interest" in the shares of companies. Section 89 (4) grants Central Government to frame rules for the same. Ministry of Corporate Affairs (MCA) has notified rules under section 89 (4), effective from April 1, 2014 that mandates person to disclose any beneficial interest in company from date of acquisition. These provisions should be strictly enforced to track down shell companies and real their owners.

An effective strategy against shell companies would call for collaboration among financial institutions, RBI, FIU and other domestic and foreign law enforcement agencies too, because of the international dimensions to their operations.

Other elements of the strategy should include a central KYC registry to track multiple transactions by one individual or entity will help create transaction histories of individuals and entities. RBI should strictly enforce such KYC norms and penalize financial institutions violating them. FIU should track down suspicious foreign transactions based on identified and carry out an analysis of their backward and forward linkages in order to understand the nature and legitimacy of the transmitted funds.

India is member of Financial Action Task Force (FATF), the world's standard-setter and enforcer of anti-money laundering standards. FATF rule states that "countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities." Indian enforcement agencies in cooperation with foreign authorities should check of peril of shell companies in money laundering.

SEBI should strengthen the KYC system to identify beneficial owners of the P-notes to restrict their usage in money laundering. There is need to strength its integrated market Surveillance System (IMSS) and Data Warehousing Business Intelligence System (IMSS) to monitor the stock manipulation involving shell companies. Also, merely debarring these companies from market in not a strong deterrent and so, enforcement needs to be stricter enforcement.

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Strict and swift action acts as a strong deterrent. Entities with no commercial substance for a given period, say 5 years, should be weeded out or frozen. Promoters and gatekeepers like bankers, accountants, auditors, valuers etc., who facilitate shell operations, should be punished under the tougher Prevention of Money Laundering Act (PMLA) and under the stringent provisions of the Companies Act 2013.

Given the tough challenge, ending the menace of shell companies would need a collective effort with a strong, punitive and immediate deterrent mechanism, supported by diligent investigations and strong judicial decisions sustained over a long period of time. There are no shortcuts to a highly complex global phenomenon.

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Thought Arbitrage Research Institute is a not for profit, think tank working in the areas of public policy, economics, sustainability and governance.

<sup>1</sup> The Economist. "The Incorporation Business: They Sell Sea Shells." 7 April, 2012.

<sup>2</sup> OECD (2011). Misuse of Corporate Vehicles for Illicit Purposes

<sup>3</sup> Findely et al. (2012) Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies

<sup>4</sup> SIT Report (2012). Shell companies and Beneficial ownership

<sup>5</sup> SIT Report (2012). Shell companies and Beneficial ownership

<sup>6</sup> The Puppet Masters, The World Bank and UNOCD , 2011

<sup>7</sup> SIT Third report on Black Money, 2012

<sup>8</sup> Black Money: White Paper, May 2012. Ministry of Finance, Government of India

<sup>9</sup> Cracking the shell: The myriad world of shell companies, round tripping and black money of India, Financial Express, 2 August 2016

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