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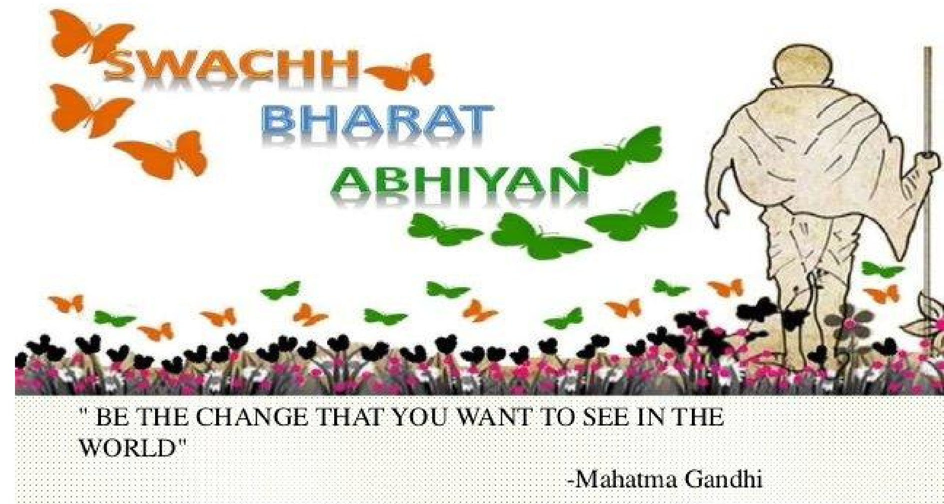
Swachh Bharat Abhiyan



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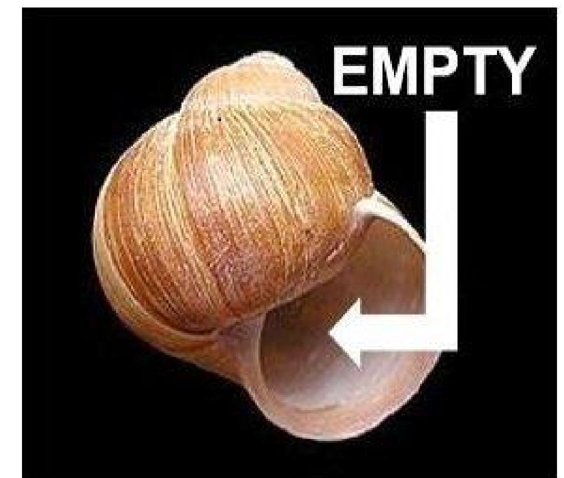
Introduction

With gusto and speed, the Modi Government is all set to clean India, not only of its littering but also of the nefarious activities undertaken by corporates and individuals alike. Take for instance, the swiftness with which the Government has acted on the Nirav Modi case, which is highly commendable; not to mention that the Government did burn its fingers in the Vijay Mallya case.

One of the many aims of the Modi Government is to prevent money laundering, counterfeiting, hoarding and tax evasion. In 2016, when the Special Investigation Team (SIT) on black money reported that a large amount of unaccounted wealth was stored and used in the form of cash by shell companies, using the stock exchange platform, and helping convert black money into white, the Modi Government demonetized currency notes of Rs.500 and Rs.1,000 overnight. It then came to light that about 35,000 shell companies had deposited and withdrawn (money laundering) about Rs.17,000 crores after demonetization. On further investigation, the Government identified around 2,24,000 shell companies and began taking action against these companies

There is no concrete definition of the term 'Shell Companies' either under the Companies Act or in any other law and there is no clarity on the kind of activities that would categorize a company as a 'shell company'. Going by the general definition, a 'shell company' is like a shell (with an outer covering while the inside is hollow), i.e. an entity without any active business operations or significant assets but serving as a vehicle for business transaction.



The discussion on existence of such shell companies (or non-operative companies) is drawing attention and the Government has stated that action will be initiated against companies which have been formed to launder money and do not carry on any business. The Government has given such companies (which account for 30% of incorporated companies) an ultimatum to either ensure various compliances and commence their business activity or cease existence.

While this step will monitor and curb laundering of monies and keep a check on the promoters, who incorporated such companies for mere circulation of funds by creating layers of companies and making it difficult to track and trace the actual beneficial owners, what is the fate of the creditors, stakeholders and others holding interest in such companies? How do they get their money back? Do they wait for 20 years or do they revive the company or will the Registrar ensure that all creditors are first paid off before the company is struck off the register?

It appears that several of these shell companies are also listed on the stock exchanges, and hence the Ministry of Corporate Affairs ("MCA") adopted an indirect route to target them through the market regulator, the Securities and Exchange Board of India ("SEBI"). The MCA identified a list of 331 suspected shell companies listed on the stock exchanges and asked SEBI to initiate regulatory action. On August 7, 2017, the SEBI issued a communication to the stock exchanges forwarding the list of 331 suspected shell companies and seeking all trading in such listed companies to be placed in Stage VI of the Graded Surveillance Measures, which places the trading in those stocks under significant limitations, thereby affecting the liquidity of the stock of those companies. The stock exchanges were in turn asked to verify the credentials and fundamentals of those companies, and conduct forensic audit of those companies and then suitably determine the consequences based on the results of the investigation/forensic report. As widely reported in the media, SEBI's move was received with considerable consternation by the markets, which were taken by surprise.

In a step to further curb the activities of such shell companies, the MCA, on September 20, 2017, notified new limits for companies having layers of subsidiaries; whereunder companies were allowed to have only two layers of subsidiaries.

The Companies Act already contains a provision (Section 186(1)), which restricts the layering of subsidiaries, in particular investment companies, so as to prevent siphoning-off of funds through such multiple layers – thereby making it clear that the introduction of genuine, operational subsidiaries, which are not principally mere investment vehicles, is a permitted exercise of corporate investment structuring between holding companies and as many layers of operating subsidiary companies as may be commercially justified.

This amendment restricts a holding company from having subsidiaries beyond two layers. In 2005, the J.J. Irani Committee Report strongly opposed the move to have any restriction on the number of subsidiaries that a holding company may have. This opposition was principally founded on two threads of analysis: firstly, as the Irani Committee Report itself very succinctly states, "The Companies Act should not pre-empt the decision as to what structure is appropriate for controlling businesses. Such prescriptions will make the environment rigid and put Indian companies at a disadvantage vis-a-vis their competitors internationally. Such restrictions would also not facilitate sound corporate planning, formation of joint ventures, international operations or restructuring of companies." Secondly, "Isolated instances of misuse of the holding-subsidiary structure should not result in doing away with this very important business model [namely, the holding-subsidiary structure], for investment and corporate planning. Instead of prohibiting formation of subsidiaries, there should be adequate disclosure obligations as to utilisation of the funds raised or loans and advances given by the coming to other entities."

The Government will also remove the exemption available to firms with tax liability of up to Rs.3000 from filing income tax returns beginning next financial year. The income tax department would now track investments by these companies. The focus will be on those firms that show less profit and those who file income tax returns for the first time. In order to prevent abuse by shell companies or by companies holding benami properties, the Government has proposed to amend the provisions of the Income Tax Act. It has come to light that as many as 500,000 companies are not filing returns and they could be a potential source of money laundering.

While the action of the Government is laudable, does one size fit all? Is it true in this case that what applies to the goose applies to the gander? We all know that after the SEBI notified 331 companies as shell companies, two operating companies had to approach SAT to omit their names from the list of 331 companies. This move increased litigation and diverted management time, not to mention damage to the reputation of promoters and their operating companies, which are still trying to convince SEBI that they are not shell companies

Did any of these actions, i.e. demonetization, imposing trading restrictions in scrip of 331 shell companies or layering of subsidiaries achieve the desired effect? While it may have curbed some of the activities, what is the guarantee that companies and individuals will not find other ways to launder money?

The one thing that these actions did achieve was to adversely affect business and the economy. Companies will now have to sit at their drawing board again for corporate planning, formation of joint ventures, international operations or restructuring their companies, given the restriction on the number of subsidiaries that they can use. Instead of applying one formula across the board, the Government should pick up those companies which were known to launder money or are actual shell companies and enforce strict action against them. Such action would have enforced confidence in the Modi Government and instilled fear to those contemplating money laundering.

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