LAYERING OF SUBSIDIARIES IN INDIA

With the advent of the new Companies Act of 2013, the old law of 1956 was revamped to a huge extent with the purpose of making it easier for people to form companies for businesses. The intention behind the legislature in creating a new law altogether for governing companies in India was to promote ease in doing business, attracting more foreign capital, and to bring the Indian law in this regard on par with global standards. The new Act of 2013 had also introduced many reforms with the intention of ensuring that Indian laws are not misused for nefarious and corrupt purposes.

One such set of provisions introduced for the purpose of preventing laundering of money and ensuring that legitimate business practices are regulated well was made with respect to layering of subsidiaries.

Previously, the law allowed creation of multiple layers of subsidiaries of parent companies. Such a scheme was often misused for the purposes of laundering money, hiding important financial information under the garb of extensive accounting reporting, and creating vast and complicated business structures which enabled nefarious business practices without attracting much attention.

All of this changed 2017 when the Ministry of Corporate Affairs notified some provisions of Companies Act, 2013 pertaining to layering of subsidiaries. The government also came up with rules specifically dealing with layering regulations. These rules complimented the government's systematic crackdown on black money and created a well-regulated structure to limit how companies can create subsidiaries. These efforts began with some important Gazette Notifications dating back to this period.

How did these Notifications come into effect?

A "subsidiary company" or a "subsidiary" under the Companies Act, 2013 has been defined under Section 2(87) as follows:

"Subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—

(i) controls the composition of the Board of Directors; or
(ii) exercises or controls more than one-half of the total share capital
either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

Explanation.—For the purposes of this clause,—
(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;
(b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;
(c) the expression "company" includes any body corporate;

(d) "layer" in relation to a holding company means its subsidiary or subsidiaries;

This entire definition, except the proviso and clause (d) of the Explanation, came into effect on 12 September, 2013; while clause (d) itself was notified later on 1 April, 2014. This means that companies at this point of time were allowed to create as many subsidiaries as they wanted for any reasons like strategic planning, ease of administration, diversification and targeted expansion.

The idea of restricting the number of permissible layers of subsidiaries was implemented last year when the Ministry of Corporate Affairs (MCA) notified enforcement of the proviso to Section 2(87) vide Notification S.O. 3086(E), dated 20 September, 2017. On the same day, another Notification, G.S.R. 1176(E), was published by the MCA to bring into force the Companies (Restriction on Number of Layers) Rules, 2017 ("Rules").

It is interesting to note that prior to these Notifications, the MCA's proposed amendments to the law had suggested omission of these provisions when the Companies (Amendment) Bill, 2016 was first tabled in the Lok Sabha for deliberations. Clause 2(xii) of the Bill had sought omission of the proviso and clause (d) of the Explanation under Section 2(87), while Clause 60 suggested deletion of sub-section (1) of Section 186, which prohibits companies from making investments through more than two layers of investment companies. Had it been approved, this amendment, in effect, would have completely withdrawn the government's powers to impose restrictions on any kind of layering of companies.

This situation changed last year when the Bill was referred to a Parliamentary Standing Committee on Finance for proposing amendments to it. Although the Committee's report did not state anything explicitly on this issue, and not many Members of Parliament had expressed concerns over it, one particular incident that occurred during this period prompted the government to retain its power to restrict layering of subsidiaries: Demonetization.

According to a statement released by MCA[1] on 12 September, 2017, around 2.10 lakh defaulting companies were de-registered and over 1 lakh directors of these companies had been identified for disqualification following the government's crackdown on black money after November 2016's demonetization. This press release had stated that the Rules to restrict companies from creating more than two layers of subsidiaries had been enforced "in the light of the evidence with respect to abuse of the Corporate Structure through multi-layering."

Even the Prime Minister's Office had ordered creation of a Task Force in February to probe instances of money laundering and tax evasions conducted by shell companies. The fact that a specialized body like this was created only to deal with shell companies indicates that the menace of black money was one of the primary reasons for the government to restrict layering of subsidiaries.

Analysis of the Rules

[1] http://pib.nic.in/newsite/PrintRelease.aspx?relid=170719

MCA's Notification states that no company shall have more than two layers of subsidiaries after the commencement of these rules (20 September, 2017). Prospective application of the Rules indicates differential treatment being meted out to companies that had already created multi-layered structures prior to the commencement of these Rules and those which proposed to do so thereafter.

These Rules, however, do not restrict "a company from acquiring a company incorporated outside India with subsidiaries beyond two layers" if such layers are permitted by laws of those countries. In this context, it can be argued that since the Rules have used the term "company" in general context without specifying jurisdictions under which they are incorporated, even foreign companies, like their Indian counterparts, cannot hold more than two layers of subsidiaries in India.

Exceptions to the rule

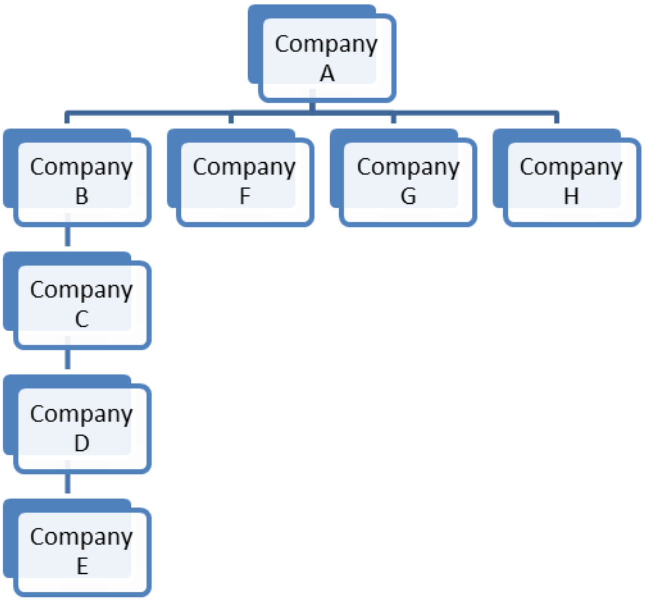
It must be noted that the MCA has also not envisaged a blanket ban on creation of subsidiaries, and the following kinds of companies are exempted from restrictions of layering:

a) Banking companies
b) Non-banking financial companies (NBFCs)
c) Insurance companies
d) Government companies

Computation of layers

For computation of number of layers permissible by these Rules, a layer which consists of one or more wholly owned subsidiaries is not be taken into account. Restrictions on layering come into the picture only when subsidiaries themselves create further subsidiaries.

Consider the chart given below. Holding Company A is allowed to have as many wholly owned subsidiaries it wants. This is why Companies B, F, G and H are perfectly legal, and Company A can further create more subsidiaries on that level. The Rules prohibiting more than two layers of companies get attracted only when these subsidiaries create their own subsidiaries. Therefore, Company B can further create Companies C and D for any reason, but Company E will be considered illegal as per the Rules as it will amount to a third layer.



One interesting point of debate that arises with regards to computation of layers is whether the Rules impose no restrictions at all on creation of wholly owned subsidiaries by not considering them while computing permissible layers. A literal interpretation of this rule states that a parent company can hold as many wholly owned subsidiaries as it wants without attracting provisions of these Rules. Restrictions on having more than two layers will apply only to further subsidiaries that these prior-mentioned subsidiaries will create.

On the other hand, a more purposive interpretation of this rule could suggest that allowing a holding company to create as many wholly owned subsidiaries as it deems viable, but also restricting these subsidiaries from creating their own subsidiaries, goes against the legislative intent behind these Rules, which is to curb creation of shell companies that facilitate money laundering and tax evasion.

Disclosure requirements

In case companies had subsidiaries in derogation to these Rules at the time of their commencement, such companies were mandated to file with the Registrar necessary details sought in a form attached therein within a specified period of time. These details include names of such companies, their CIN identities and percentage of share owned by holding companies. Companies were also prohibited from having more subsidiaries than permissible henceforth.

Penal provisions

In order to ensure compliance with the Rules, companies and their officers are made liable to a fine of Rs. 10,000 for contravention of any provision. Continuing contraventions can further be fined by Rs. 1,000 for each day such contraventions continue.

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