

LAYERING OF SUBSIDIARIES UNDER THE COMPANIES ACT, 2013

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BACKGROUND

In order to curb black money, the government has been constantly making attempts (demonetization, Goods and Service Tax, RERA laws etc.) to encourage good governance culture. The Companies Act, 2013 (“**2013 Act**”), to scrutinize the misuse of multiple layers of subsidiaries forbids certain holding companies from constituting layers of subsidiaries beyond a prescribed number² and also stipulates that no investment can be made by a company via more than two layers of investment companies³. The Companies Law Committee (“**CLC**”) established by MCA suggested for the omission of the above-mentioned provisions. According to the Committee, such restrictions may hinder the modern business world and prove to be too obtrusive, thereby impacting the ability of the companies to raise funds.⁴ However, the government retained the provisions, seeing the reports of the misuse by multi-layered companies to create shell companies for money laundering. A draft notification containing the rules to be prescribed were placed for public comments in June 2017.

Finally, pursuant to the powers conferred under Section 2(87), the Ministry of Corporate Affairs (“**MCA**”) on 20th September, 2017 notified the Companies (Restriction on Number of Layers) Rules, 2017 (“**Layering Rules**”) in order to regulate the multiple layers of subsidiaries; accordingly clamp down the malpractice of siphoning or diversion of funds. Furthermore, the provisions of Section 186 of 2013 Act have been amended in regards with investment companies.

1. RESTRICTION IMPOSED

No company can any longer have more than two layers of subsidiaries. The 2013 Act provides for the definition of subsidiary as a company in which the holding company (on its own or along with other subsidiaries) either controls the structure of Board of Directors

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² Companies Act, 2013, § 2(87)

³ *Ibid*, § 186 (1)

⁴ Ministry of Corporate Affairs, Government of India, *Report of The Companies Law Committee*, 21-22 (September 8, 2020) https://www.mca.gov.in/Ministry/pdf/Report_Companies_Law_Committee_01022016.pdf

or controls more than half of the total share capital. The rules apply to all the companies incorporated under the 2013 Act or any other previous companies act, therefore including the body corporates which comprise of companies incorporated outside India. Henceforth, it can be safely concluded that company outside Indian can't have more than two layers of subsidiaries in India also.

It is pertinent to point out that the restriction applies to the vertical subsidiaries only and not to the horizontal subsidiaries; thereby clearing that the rules aim to limit the number of layers of subsidiaries and not the number of subsidiaries.

2. COMPLIANCE REQUIREMENTS

The layering rules have a prospective effect. All the companies having more than two layers of subsidiaries (leaving out the exempted companies), existing on or before the notification of the rules, that is 20th September, 2017 shall have to file a Form CRL-1 with the Registrar of the Companies ("ROC"), 150 days from the commencement of the rules in order to disclose the details specified in the form.

Also, after the notification, no such company shall have any additional layer of subsidiaries beyond the existing layers on that date.

3. EXCEPTIONS

- The following set of companies have been exempted from the restriction of two-layers-
 - Banking company⁵
 - Non-banking Financial Companies⁶
 - Insurance companies⁷
 - Government companies⁸

- Also, there is no prohibition over Indian companies in acquiring foreign companies with more than two layers of subsidiaries; only if such layering is in conformity with the jurisdictional laws of the foreign company. It must be marked down that the Layering Rules apply to the body corporates that encompasses those companies

⁵ Defined under Section 5 (c), Banking Regulation Act, 1949

⁶ Defined under Section 45-I (f), Reserve Bank of India Act, 1934

⁷ Defined under Insurance Act, 1938 and Insurance Regulatory Development Authority Act, 1999

⁸ Companies Act, 2013, § 2(45)

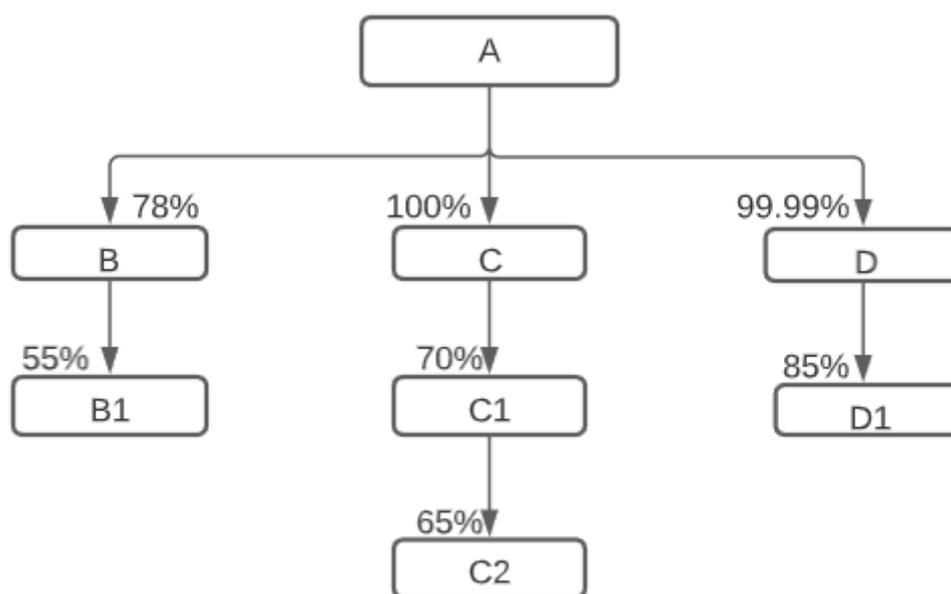
too that have been incorporated outside India. Thus, it can be safely concluded that foreign companies cannot have more than two layers of subsidiaries in India.

- The rules further provide that the layer consisting of one or more wholly owned subsidiary (“WOS”) won’t be taken into consideration. This is done in order to facilitate the flourishing of genuine businesses that have clear source of capital.
- According to Section 186 (1) of the 2013 Act, no company shall make an investment through more than two layers of investment companies. The proviso to the present section exempts the following companies-
 - Company acquiring foreign companies having more than two layers of subsidiaries
 - Subsidiary company that has investment subsidiaries for the purpose of meeting the requisites under law.

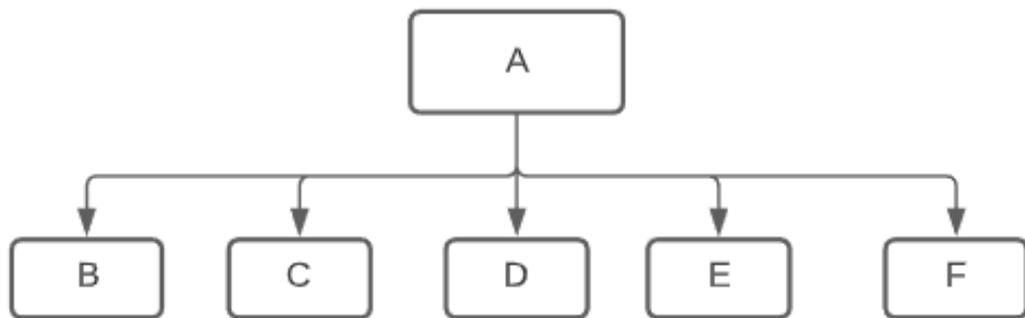
The Layering Rules clearly specify that they are not in derogation of the proviso of Section 186 (1) of the 2013 Act.

4. ILLUSTRATION

- This illustration envisages the structure permitted under the rules.



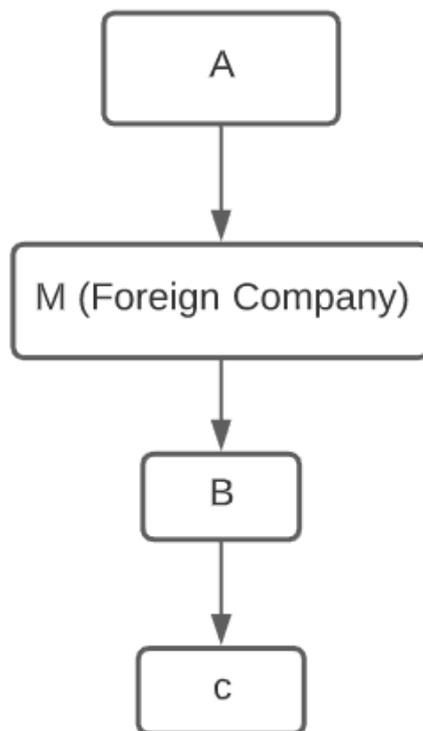
- In this illustration, A is the holding company and B, C, D, E and F are the subsidiaries of A. Such an organization of the company is allowed as the restriction is imposed only on vertical structure and not on horizontal structure and all of the subsidiaries mentioned fall under the first layer.



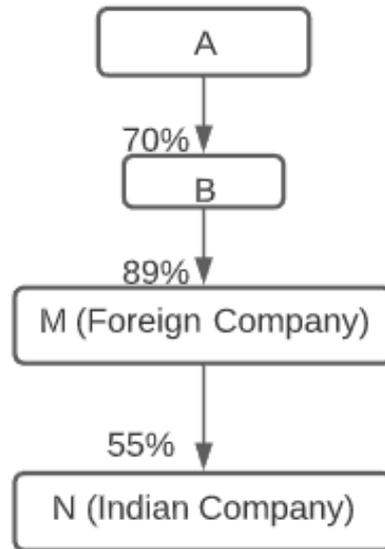
- In this illustration, A is not contravening the rules as M is a foreign subsidiary and the companies are allowed to acquire all those companies incorporated outside India with more than two layers.



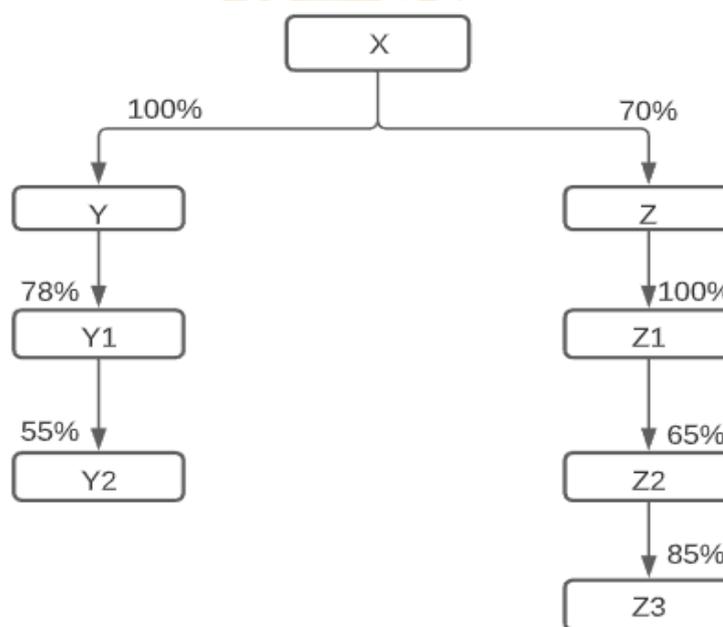
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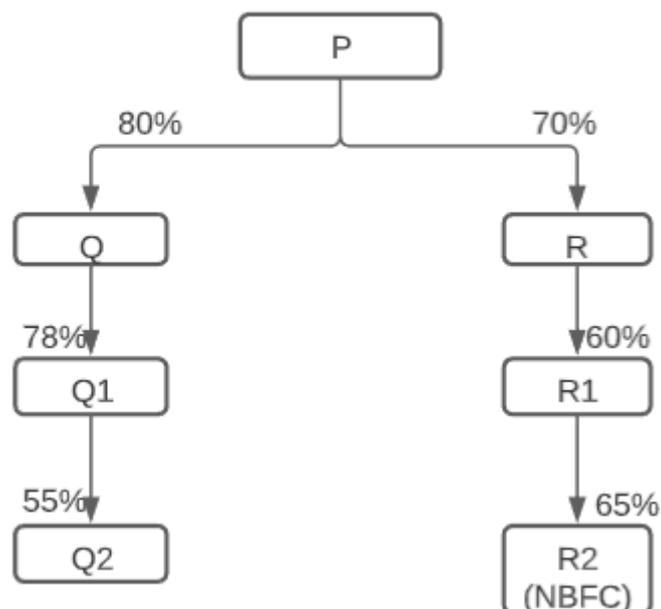
- In this illustration, M is a foreign company and has made an investment in N, an Indian company. Such an organization will not be permitted as investment in layers of Indian subsidiaries is limited to two layers and such a limitation cannot be circumvented by investing through a foreign subsidiary.



- In this illustration, Y being a WOS of X will be exempted and thus the permitted layer will be till Y2. On the other hand, Z is not a WOS of X and hence the permitted layer for X will be till Z1 and for Z, the permitted layer will be till Z3.



- In this illustration, Q2 not falling under any exceptions, contravenes the rules and permitted layer will be till Q1. However, R2 being a NBFC is exempted from being taken into account as a layer and the permitted layer will be till R2.



5. NON-COMPLIANCE CALLS FOR PENALTY

The new rules provide that, in case of any contravention, the company and each and every officer of the company involved in such a default shall be fined up to a maximum of Rs. 10,000. In addition to this, if the contravention continues, the fine may extend to a maximum of Rs. 1000 per day till the contravention continues.

6. CONCLUSION

The restriction put on layering provides for the regulating of existing framework with more than two layers of subsidiaries, given that the companies with more than the prescribed layers will have to file the mandatory return with the ROC. The rule will assist in keeping a close watch on the operation of various layers of holding-subsidary structure meant for diversion or siphoning off of funds. In addition to this, the authorities will be empowered enough to identify the ultimate beneficiary of the complicated corporate structures. In addition to this, ignoring one layer of WOS is a great move to facilitate businesses.

Regardless of how, the limitation may prove to be an issue for the companies as the operational flexibility in relation to mergers and acquisitions involving multiple layers of subsidiaries may be impaired. Also, the broad definition of subsidiaries may demonstrate as a challenge along with the interpretive quandary that may come along the loosely worded ambiguous rules. The rules lack clarity as to what comprises a layer. For instance, if the rules are read literally, they apply to each company and accordingly, each layer could have

two more layers before them. Such interpretation is inconsistent with the intent of the legislation of restricting the number of layers and therefore a rational way to interpret would be to apply the rules only to holding companies.

