

# **Shell Companies**

By

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## **Introduction**

Shell companies are often associated with fraud. Although they are legal entities that do have a legitimate function in business operations, shell companies are also utilized by criminals to facilitate fraudulent activities. Such activities include money laundering, billing schemes, fictitious service schemes, bankruptcy fraud, tax evasion, and market manipulation. Scandals involve anywhere from thousands to millions of dollars.<sup>1</sup> While shell companies are frequently linked to multiple forms of scams, law officials are unable to prosecute all cases because state agencies do not collect enough ownership information on company formation documents. Thus, leaving no paper trail for the government to trace back to a particular individual or individuals.

## **Definition**

A shell company is an entity that has no active business and usually exists only in name as a vehicle for another company's business operations.<sup>2</sup> In essence, shells are corporations that exist mainly on paper, have no physical presence, employ no one and produce nothing. They are frequently used to shield identities and/or to hide money. A shell company can often be identified by a number of red flag indicators including:

- No phone number
- No e-mail address
- No physical address
- No company logo
- No contact person
- No federal identification number

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<sup>1</sup> GAO report, page 1

<sup>2</sup> Black's Law Dictionary

## **Formation**

Forming a shell entity is a simple process, especially since there are a number of ways to create a company. The principal owner of the business, an attorney or individual acting on behalf of the business, or a third-party agent may submit the filings and necessary paperwork to the state for company formation. They can submit by mail, in person, by fax, or online via e-mail. The typical information required by the states includes: Company name; name and address of agent for service of process; number or type of shares (if corporation); names, addresses, or signatures of incorporators or organizers, and filing fees. Usually, the division of secretary of state's office or another related state agency handles the paperwork. They check for the availability of the desired company name, make sure all required information was filled in and completed, and process the payment. Information collected from applicants is not verified. The state then makes a decision to accept, suspend, or reject the formation. The whole process can be anywhere from five minutes to 60 days.<sup>3</sup>

Depending on the business' purpose, the business owner(s) can choose to create a corporation, a limited liability company (LLC), a partnership, or a sole proprietorship. Corporations and LLCs offer limited liability to owners of the company, giving these entities a distinct advantage. In other words, the owner's personal assets are not held accountable in lawsuits if any are brought against the company. However, an LLC offers the best of both worlds. As a hybrid, an LLC also shares the tax benefits that partnerships and sole proprietorships benefit from. Profits are only taxed once by the

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<sup>3</sup> GAO report, page 8, Figure 1

government, compared to corporations, which are double taxed (once for corporate profits and again for distributions to shareholders).<sup>4</sup>

LLCs increasing popularity over the past decade can be attributed to its hybrid like features; offering both limited liability to owners and the avoidance of double taxation. According to the IACA, LLC formations have increased by nearly 92% between the years 2001 and 2004.<sup>5</sup> The top four states for corporation and LLC formations are Florida, New York, Delaware, and California. The most popular formation state for both corporations and LLCs in 2004 was Florida. However, New York had the largest number of corporations on file in 2004 and Delaware had the largest number of LLCs.<sup>6</sup>

A majority of states require corporations and LLCs to file periodic reports, though few states actually require ownership information to be present on the reports. Alaska and Maine are the only states that require both corporations and LLCs to file reports with owner names and addresses on them. All states except for Colorado and Pennsylvania require either a name or address, if not both, for managers and directors of corporations and LLCs on periodic reports.<sup>7</sup> Information that is collected by state filing agencies is not verified because they lack the authority and resources to investigate. The state agencies that do find anything out of the ordinary tend to contact the applicant(s) for questioning, but usually end up filing the reports or formation documents nonetheless.

For foreign persons or entities, requirement information for owners, managers, and directors is the same as it is for United States citizens or entities. A few states do

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<sup>4</sup> GAO report, page 10, Table 1

<sup>5</sup> IACA is a professional association for government administrators of business organization and secured transaction record systems at the state, provincial, and national level in any jurisdiction.

<sup>6</sup> GAO report, page 12, Figure 2

<sup>7</sup> GAO report, pages 16 & 18, Figures 4 & 5

require proof of the company's existence and/or that documents be translated into English. "Alaska is the only state that requires the name and address of each alien affiliate or a statement on the articles of incorporation that there are no alien affiliates. An 'alien affiliate' is an individual from another country who has some ownership control of a company or an entity controlled by an individual or a corporation from another country."<sup>8</sup>

For a fee, company formation agents assist individuals with forming a company by filing required documents on their behalf. They can also serve as the agent for service of process, file any periodic reports for the company, or assist in setting up business bank accounts. States that do require a name and address for company formation agents seldom verify their identities. Few states, such as Wyoming, require that formation agents that represent five corporations or more annually register with the state agency. Agents are subject to the laws of the jurisdictions in which they operate. That being said, since the states do not require them to do so, formation agents generally do not require any ownership information from their clients. However, several agents did state that they used the Office of Foreign Assets Control (OFAC) list to screen names on formation documents.<sup>9</sup> Other countries, such as the UK, do require agents to verify the identity of the customer before processing the necessary paperwork.

Delaware, Wyoming, and Nevada are the top three states for shell company formations, with Delaware being number one. These three states require minimal

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<sup>8</sup> GAO report, page 21

<sup>9</sup> OFAC is the Office of Foreign Assets Control. It is an office within the U.S. Department of Treasury that administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals, as well as a master list of "Specially Designated Nationals and Blocked Persons" (SDN) that includes numerous foreign agents and front organizations, terrorists, terrorist organizations, and narcotics traffickers. Undertaking any type of business or financial transaction with a person or entity on this list is illegal under federal law.

information from the owner(s) on formation documents, thus an indication that criminals are less likely to be identified. For increased anonymity, both Wyoming and Nevada permit companies to have bearer shares and nominee shareholders. Bearer shares shield identities in the corporate structure and nominee shareholders are used in privately held organizations to conceal ownership information.<sup>10</sup> As of November 2005, state company formation fees for Corporations and LLCs in Delaware, Wyoming, and Nevada were:<sup>11</sup>

	<u>Corporations</u>	<u>LLCs</u>
Delaware	\$50	\$90
Wyoming	\$100	\$100
Nevada	\$75	\$75

Alaska, Arizona, and Maine have the strictest regulations/rules for company formations; therefore, the two states are the least likely to contain shell entities. “In Alaska, any person owning more than 5 percent interest in a corporation must be listed on the periodic report.”<sup>12</sup> As of November 2005, state company formation fees for Corporations and LLCs in Alaska, Arizona, and Maine were:

	<u>Corporations</u>	<u>LLCs</u>
Alaska	\$250	\$250
Arizona	\$60	\$50
Maine	\$145	\$175

### Crimes

Shell companies have become progressively more known for their involvement with illegal activities, including:

- Money Laundering
- Billing Schemes
- Fictitious Service Schemes
- Bankruptcy Fraud

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<sup>10</sup> U.S. Money Laundering Threat Assessment, Chapter 8 pg 47

<sup>11</sup> GAO report, page 60, Table 3

<sup>12</sup> GAO report, page 15

- Tax Evasion
- Market Manipulation

## Money Laundering

Money laundering is the process of taking money obtained from illegal actions and making it seem like it was acquired from legitimate sources. Criminals launder money to prevent being linked to illegal activity. The most common types of money launderers include drug traffickers, embezzlers, corrupt politicians, mobsters, terrorists, and con artists.<sup>13</sup> The three basic steps of the money laundering process are:

1. **Placement** – The launderer will input illegally obtained money into a legitimate financial institution. Banks are required to report high-value transactions, so usually the money will be deposited in small increments over a period of time. This is known as the riskiest stage of the process.
2. **Layering** – This includes wire transfers and bank-to-bank transfers to spread the money out among various financial institutions. The criminals will usually set up accounts under other names at different banks in different countries. While transferring the money in between the various bank accounts, the money is used to purchase high cost items (boats, houses, cars, diamonds) to change the form of it. The whole idea is to make the money as untraceable as possible; therefore, it's considered the most complex step of the process.
3. **Integration** – This step involves the money re-entering the mainstream economy in legitimate form. The money appears to come from a legal source and therefore is usable by the launderer(s).<sup>14</sup>

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. The dirty money is then put into the bank account, making it seem as though it was obtained legitimately. A person may

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<sup>13</sup> The Financial Action Task Force (FATF), created in 1989, is an inter-governmental body whose purpose to combat money laundering and terrorist financing through policy making.

<sup>14</sup> <http://money.howstuffworks.com/money-laundering.htm>

open various accounts across the United States or overseas and use shell companies as a means to shield their true identities. Since states do not require certain ownership information, it is extremely hard for law enforcement officials to trace the money back to the original creator of the shell entity. “For example, an Immigration and Customs Enforcement (ICE) official provided an example of a Nevada-based corporation that received 3,744 suspicious wire transfers totaling \$81 million over a period of two years. However, the case was not prosecuted because ICE could not identify the beneficial owner of the corporation.”<sup>15</sup> The ICE has encountered a number of investigations in which shell companies have been established in the United States by international individuals. However, many cases were closed due to the lack of information needed to investigate further.

It was reported in the U.S. Money Laundering Threat Assessment by the Financial Crimes Enforcement Network (FinCEN) that there were 397 suspicious activity reports (SARs) filed by financial institutions between the years 1996 and 2004. The SARs included both U.S. shell companies and Eastern European countries totaling approximately \$4 billion.<sup>16</sup> Russian organized crime, in particular, has become a concern to the United States. Criminals have used U.S. banks, such as the Bank of New York to launder illegally obtained money and money to be hidden from the Russian government. “In 1999, four individuals and two companies were indicted by the United States in connection with the laundering of more than \$7 billion.”<sup>17</sup>

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<sup>15</sup>GAO report, page 6

<sup>16</sup> GAO report, page 31

<sup>17</sup> U.S. Department of Justice. “The Threat of Russian Organized Crime”

Offshore business and banking is also linked to shell companies and money laundering. Intermediaries, called Nominee Incorporation Services (NIS), assist with the formation process of companies and/or bank accounts on behalf of foreign clients for a fee. They may be located offshore or in the United States.<sup>18</sup> Essentially, the third-party nominee will fill out the proper documentation needed to form the company and then acts as a director or manager of the newly formed offshore company.<sup>19</sup> The offshore services are an attraction for those looking to keep their identity hidden. The FBI has raised concerns in regards to company formation agents creating shell companies in the United States that are operated by people living in other countries.

Money laundering and organized crime have become crucial concerns for financial institutions and governments around the world. Specialized governmental agencies labeled “financial intelligence units” or “FIUs” were established in countries around the world to aid in the prevention of money laundering and organized crime. “They offer law enforcement agencies around the world an important avenue for information exchange.”<sup>20</sup>

In 1995, a group of FIUs met in Brussels at the Egmont Arenberg Palace and established what is now known as the Egmont Group. Consisting of 101 countries with FIU units, the Egmont Group exchanges information and expertise with one another in their attempt to battle money laundering and other forms of organized crime. A complete list of the countries that are members of the Egmont Group is available on its website, [www.egmontgroup.org](http://www.egmontgroup.org). The United States is a member.

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<sup>18</sup> U.S. Money Laundering Threat Assessment, Chapter 8 pg 47

<sup>19</sup> <http://www.offshoresimple.com/nominee.htm>

<sup>20</sup> [www.egmontgroup.org](http://www.egmontgroup.org)

## **Billing Schemes**

Shell companies are also involved in billing schemes, a form of occupational fraud. Occupational fraud is divided into three categories: corruption, fraudulent statements, and asset misappropriations. Billing schemes fall beneath the asset misappropriation category of occupational fraud. There are two forms of billing schemes: shell company schemes and pass-through schemes.

In a shell company scheme, an employee, usually involved with purchasing, will create a false vendor to submit fake invoices for payment to their employer. The employer will pay the invoice assuming it was for legitimate services. The payment is then deposited into a falsified business bank account allowing the money to be accessible to the criminal or criminals.

In a pass-through scheme, an employee will create what seems to be a legitimate business and use it to purchase goods or services from their employer. Thereafter, they mark the goods up and then sell back to their employer, pocketing the profit from the mark-up.

Red flag indicators for billing schemes include:

- Invoices for unspecified services or “soft” billings such as consulting or advertising
- Unfamiliar vendors
- Vendors with P.O. Boxes only
- Vendors with company names consisting of initials only
- Rapidly increasing purchases from one vendor
- Vendor billings more than once a month
- Vendor addresses that match employee addresses
- Large billings broken into multiple smaller invoices
- Internal control deficiencies
- Unfolded invoices which may indicate they weren’t mailed

## **Fictitious Service Schemes**

Fictitious service schemes are another type of scam that shell companies are connected with. A criminal will create a false company and then enter into a contract with another business offering an intangible service, such as consulting. When payments are received from the legitimate business for alleged consulting services, the criminals deposit the money into their own accounts. Unfortunately, fictitious service schemes are tough to take legal action against. Since a number of state agencies don't collect enough information pertaining to company formations, it's difficult for authorities to identify the criminal(s) for prosecution.

According to a Department of Justice report on Russian money movements, fictitious service schemes are one of the common mechanisms utilized by foreign individuals to conceal money movements.<sup>21</sup> “In one case...a former public official from the Russian Federation allegedly helped to unlawfully divert international nuclear assistance funds that were intended to upgrade the safety of nuclear power plants operating in Russia and several former republics of the Soviet Union. The indictment stated that the suspects formed shell companies in Pennsylvania and Delaware that received the nuclear assistance payments and then diverted over \$15 million of this money to corporate bank accounts. Ultimately, the money was allegedly transferred to other personal bank accounts in the United States and other countries and the transfers concealed behind fictitious business contracts.”<sup>22</sup>

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<sup>21</sup> U.S. Department of Justice. “The Threat of Russian Organized Crime”

<sup>22</sup> GAO report, page 33

## **Bankruptcy Fraud**

The use of shell companies in bankruptcy fraud is to shield assets (money, property, valuable items, etc.) from being taken by the court when filing for bankruptcy. In other words, an individual or individuals will set up a shell entity and hide their money and/or personal assets under the business name. Thus, allowing them to file for bankruptcy with the government without having to surrender their personal assets.

## **Tax Evasion and Market Manipulation Scams**

The FBI and IRS are continuously investigating instances in which shell companies have been used in tax evasion schemes and market manipulation scams. Shell companies have been used to hide personal assets under false business names in order to avoid tax liabilities, similar to the purposes in bankruptcy fraud. In regards to market manipulation, shell companies are used to stage fake stock offerings to outside investors. When the investors decide to invest in what seems like a legitimate business, the criminals steal their invested dollars.<sup>23</sup> Such fraudulent acts can be damaging to the market and hinder investor's trust.

## **A Criminal's Perspective**

Understanding the criminal mind in forming a shell entity for illegal purposes...

1. Search online for company formation agent located in Dover, Delaware (i.e. Agents for Delaware Corporations)
2. Go to location of business and request services in assisting formation of a Corporation
  - a. They file all necessary paperwork with the state and use one of their executive's names as the incorporator of the corporation for anonymity (<http://www.agentsfordelaware.com/FormingACorporation.html>)
  - b. Pay fee to the agent with cash or money order; guarantees no link

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<sup>23</sup> GAO report

- c. Obtain a P.O. Box with post office for company address
3. Open bank account at local bank in business name with state filed documents
4. Obtain a pre-paid cell phone to use as business phone (Cell phone carriers do not check background information nor verify names for pre-paid purchases and services)
5. Have some inexpensive business cards made to allude that the business is legitimate; use only the name of the business, a P.O. box, and a phone number (no contact name, no logo, and no e-mail address)
6. Submit invoices to corporate accounts payable function for professional services
7. Receive payments for professional services invoices and deposit the funds into a business bank account
8. After the checks clear or based on some external event, close the business bank account, discontinue the pre-paid cell phone number from service, and close the P.O. box that you had originally set up for mailing purposes
9. Destroy any and all paperwork associated with the professional services company

### **Resources**

The following are websites that can be used to determine more detailed background information about individuals or businesses, or to obtain up-to-date information on matters such as money laundering and/or suspicious activities:

- <http://www.dnb.com/us/> - This website allows you to search for a company by country, state, city, name, and/or zip-code and will provide a list of matches with addresses for each. For additional information, packages are available for a fee. Purchases start at \$9.99 for low credit risk decisions, which entails monitoring, including alerts of business or credit changes, and ranges up to \$139.99 for a medium to high risk credit decision involving a comprehensive in depth analysis of a company (including its background, whether it's a good choice for a long term business relationship, and its associated risk factors). Monthly on-line subscriptions are available for

frequent users of the site (free registration required), with monthly fees depending on the information desired.

- [www.kompass.com](http://www.kompass.com) - This website also allows you to search for a company or products/services in a particular country. However, the search engine has a limited reference pool, in that its search is restricted to larger known companies/corporations. The search yields an address, a telephone number, number of employees, and approximate sales from its most recent figures. Additional information can be obtained for a one-time fee or monthly subscriptions are available as well (registration required).
- [www.zoominfo.com](http://www.zoominfo.com) - This website search engine allows you to search for a person or a company for free. It gives a lot of details about the company and/or person, including company description, industry, background information, biography, what affiliations the person or company has, etc. The site serves as a networking and recruiting center, in that it allows people to sign on (at no cost) similar to AOL Instant-Messenger and you can make contacts with people and/or businesses.
- [www.europages.com](http://www.europages.com) - This website allows you to find a company located in Europe searching by business name or by product/service. Information given includes address, telephone number, type of industry, and the number of employees. Free registration is available for all users, in which you are able to receive free alerts on purchase requests or offers to sell.
- [http://ec.europa.eu/taxation\\_customs/vies/en/vieshome.htm](http://ec.europa.eu/taxation_customs/vies/en/vieshome.htm) European commission website that allows you to verify the authenticity of a business by its VAT (Value Added Tax number, similar to a tax identification number in the U.S.)
- <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/0,,pagePK:180619~theSitePK:136917,00.html> - This website allows one with free access to assess the money laundering risk of institutions or people with ties to various countries by outlining the countries political risks and corruption indicators.
- [www.imolin.org](http://www.imolin.org) - International Money Laundering Information Network that provides a source for money laundering and banking-related laws and regulations by country.

- [www.moneylaundering.com](http://www.moneylaundering.com) - The website provides 24-hour headlines about current money laundering cases and investigations, up-to-date rules and regulations pertaining to money laundering, and access to archived materials for a fee. For single users of the site, the annual fee is \$895, however, discounts are offered for multiple users and/or groups.
- [www.opencrs.com](http://www.opencrs.com) - The site hosted by the Congressional Research service offers Congressional Research Reports for people free of charge. The reports include analyses of money laundering and terrorist financing-related subjects as well as identify theft issues.
- [www.fincen.gov](http://www.fincen.gov) - The site, home to the U.S. Financial Intelligence Unit, provides guidance on rules and regulations in relation to money laundering and suspicious activity reports as well as trends and tips at no cost.
- [http://www.fintrac.gc.ca/publications/guide/Guide2/2s5\\_e.asp](http://www.fintrac.gc.ca/publications/guide/Guide2/2s5_e.asp) - Gives industry-specific red flags in regards to suspicious behavior or illegal transactions free of charge.
- [www.nationmaster.com](http://www.nationmaster.com) - Website includes lists, diagrams, and graphs that detail terrorism, crime, corruption, and other statistics by country, as well as information pertaining to the country's economy, government and level of taxation. Also enables you to create graphs and compare countries at no cost.
- <http://www.flips-search-resources.com/search.html> - Website used to verify customer identification or locate people by categories including address, phone number, e-mail address, postal address, military, and/or prison records. The site is available with free access to all users.

### **Conclusion**

In conclusion, shell companies are legal entities that are frequently used by individuals to conduct criminal behavior. Such fraudulent measures include money laundering, billing schemes, fictitious service schemes, bankruptcy fraud, tax evasion, as well as market manipulation. While authorities are continuously investigating the illegal utilization of shell entities, they are finding it difficult to prosecute those whom are

criminally involved. States do not require much, if any, ownership information on company formation documents, therefore, making it almost full proof for law officials to prosecute. Third-party agents and nominee incorporation services make it even harder for authorities to trace illegal activity to the original creator of the shell. Although regulations and laws are in place, numerous websites are available for individuals as well as businesses to search a company's history and/or to confirm identities, or search current issues regarding the fraudulent use of shell companies.

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## Glossary

*Agent for service of process* – A person or entity that is authorized to act for or in place of another to receive legal notices on behalf of a company. Agents for service of process may be known as registered agents, resident agents, statutory agents, or clerks in different states.

*Bearer shares* – Negotiable instruments that accord ownership of a company to the person who possesses the share certificate. They do not contain the name of the shareholder and are not registered, with the possible exception of their serial numbers. They may be bought, sold, or exchanged in complete privacy.

*Beneficial owner* – Shareholders with the power to buy or sell the shares in the company, but who are not registered or reflected in the company's records as the owners. A beneficial owner is the natural person who ultimately owns or exercises effective control over a legal entity, transaction, or arrangement.

*Company formation agents* – A person or business that acts as an agent for other by filing documents with officials of the selected jurisdiction for the formation of legal business entities. Such agents may also act, or arrange for another person to act, as a director or secretary of a company, a partner of a partnership, or a nominee shareholder for another person. Other business services may also be provided, such as providing a registered office, or a business correspondence, or administrative address for a company.

*Corporation* – An entity having authority under law to act as a single person distinct from the shareholders who own it and having rights to issue stock and exist indefinitely.

*Director* – A person elected or appointed to serve as a member of the board of directors for a corporation, which generally manages the corporation and its officers.

*Incorporator* – Can be the agent who is forming the company on behalf of the owners or it may be an individual affiliated with the company being formed.

*Limited liability* – Liability restricted by law or contract; esp., the liability of a company's owners for nothing more than the capital they have invested in the business.

*Limited liability company* – A company statutorily authorized in certain states that is characterized by limited liability, management by members or managers, and limitations on ownership transfer.

*Nominee* – An individual or entity designated to act on behalf of another.

*Nominee incorporation services* – Third party intermediaries that act on behalf of a foreign client by carrying out the necessary requirements to start a business; acts on behalf of another with authorization.

*Nominee shareholders* – shareholders used to shield beneficial ownership information in privately held companies.

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*Partnership* – A partnership in which all partners participate fully in running the business and share equally in profits and losses.

*Sole proprietorship* – A business in which one person owns all the assets, owes all the liabilities, and operates in his or her personal capacity.

*Third party agent* – One who is authorized to act for or in place of another.

