TRANSFER OF SHARES OF A SECTION 8 COMPANY

◆ Legal Series Vol. XVIII ◆ Issue 7

Standards & Norms

Resource support on NGO Governance, Accounting and Regulations

PREMIUM ON SHARES AND RELATED ISSUES

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INTRODUCTION

1.01 A section 8 company limited by share capital is one of the available options to register a charitable or religious organisation. It has various features which are distinct from trust and societies. It is a body incorporate and artificial legal person unlike a trust or a society. The shareholders can have control in proportion to the shareholding which is not permissible in case of a trust or a society. In other words, technically, a section 8 company limited by share capital can be controlled by one individual by holding most of the shares. In this issue, we shall discuss the law pertaining to transfer of shares of a section 8 company limited by share capital and whether a shareholder can lawfully take premium on transfer of shares.

CAN THE SHAREHOLDERS OF A SECTION 8 COMPANY LIMITED BY SHARE CAPITAL TRANSFER THE SHARES AT PREMIUM

2.01 There is no explicit bar in the Companies Act with regard to the transfer of shares of a section 8 company to another person at a higher price over and above the face value of such shares, unless the Article of Association specifically provides for the manner and restrictions on transfer of shares. However, a section 8 company by its constitution is created for charitable purposes and the shareholders as well as the directors cannot benefit directly or indirectly from their fiduciary rights which they hold in a section 8 company. In this spirit it is not advisable to transfer the shares of a section 8 company at a high premium or to value the shares based on the assets of the section 8 company.

2.02 A Section 8 company under the C*ompanies Act, 2013* is formed **for charitable purposes** and is prohibited from distributing **any profits or surplus** to its members (Sec. 8(1)(b) & (c)). However, this prohibition applies to **profits and assets of the**

company. Technically it can be argued that the gains to the shareholders from **selling their shares to another person** does not dilute or liquidate the asset or networth of the company. The text of section 8 of the Companies Act, 2013 is annexed in ***Annexure 1*.**

2.03 Any contravention of the requirements of Sec 8, including high-value transaction with regard to the transfer of shares, may attract revocation of licence(sub-section (6)) & may further subject to a winding-up proceedings (sub-sec (7) of Sec. 8 of CA, 2013).

2.04 The Bombay High Court in the case *Ashwin Jayantilal Shah v. Panjarpol Sanstha Others,* 2001 ALL MR 2 476 held that trustees of a public trust must be faithful fiduciaries and protect the interests of the trust. The court warns about secret or underhand deals by trustees benefiting themselves at the cost of the institution, highlighting the need for vigilance to prevent trustees from making improper gains**.**

2.05 In *B. Ramachandra Adityan vs Educational Truste*e Co. *(P.) Ltd*.; 2003 113 CompCas 334 Mad, the Madras High Court held that where a company formed under section 25 of the Companies Act, 1956 exists solely for getting personal advantage to any party and not in the public interest, the company is liable to be wound up.

2.06 In theory, shareholders of a section 8 company could sell their shares at a **premium** (above face value) if a willing buyer agrees and the Board approves the transfer. This premium would be a **capital gain** to the seller, **not** income from the company itself. Therefore, the gain does **not** count as a "distribution of profit" by the company, so it isn't a direct violation of Section 8(1)(b).

2.07 The **Articles of Association** of most Section 8 companies severely restrict transfer of shares. Many require that shares be transferred **at face value or nominal value** to another person approved by the Board, precisely to prevent personal enrichment.

2.08 The premium charged by shareholder should be perceived as **indirect profiteering from a charitable vehicle**, which can:

- Invite **MCA scrutiny** under *Companies Act, 2013*.

- Jeopardize the Section 8 license if seen as undermining charitable purpose.

2.09 In the light of the above, it can be concluded that a shareholder can in theory sell at a premium. However, such transactions do not seem to be consistent with the statutory intent behind creation of section 8 companies. Under normal circumstances transfers should be made at face value to avoid allegations of profiteering from a non-profit entity or any proceedings by MCA.

2.10 Technically, the shareholders may transfer the shares at a premium though such transactions do not seem to be consistent in the larger scheme of the statutory provisions. The trusteeship rights cannot be monetized and sold by the trustees.

2.11 Technically, the amount of initial contribution made against allotment of share is in the nature of corpus donation and ideally, even the face value should belong to the section 8 company and not the transferring shareholder. However, the Companies Act, 2013, has not provided any specific procedure for transfer of share of a section 8 company and therefore, conflict and confusion arise when the normal procedure of share transfer is applied to section 8 company. In our opinion, a shareholder cannot directly or indirectly benefit out of the transfer of shares of a section 8 company. Any absence or oversight in specific provisions would not entitle the shareholder to take any such benefit.

LEGAL IMPLICATIONS IF PREMIUM IS CHARGED BY SHAREHOLDERS

3.01 In case of section 8 under **Section 8(1)(b) & (c)** of the Companies Act, 2013, income and property of a Section 8 company must be applied only towards its charitable objects. Members **do not acquire ownership rights** over the assets of the company. The members also do not own the net worth of the company unlike the for-profit companies. The shares or membership in a Section 8 company cannot be sold for consideration like in a commercial company, because there is no right to dividend or profit or payout on liquidation. Membership is only for governance and participation in charitable objectives, not for financial return.

3.02 Any transaction of shares between shareholders and outside parties where one party sells the shares at premium would imply that the transferer has benefited from the net worth valuation of a section 8 company which are public property. Such transaction if investigated will require lifting of corporate veil and the real purpose of the assets of section 8 company will be under scrutiny.

3.03 The NCLT, Chennai Bench, in the case *LBR Foundation India, in re* [2025] 173 taxmann.com 339 (NCLT- Chennai), held that a section 8 company cannot buy back its share or reduce its capital. The capital received by section 8 company will have to be used for charitable purposes.

3.04 In the case *Young Indian, New Delhi v. ACIT(E)*, New Delhi, ITA 1251/DEL/2019 the ITAT of Delhi was adjudicating transactions pertaining to purchase of shares by a section 8 company of another proposed section 8 company. The Tribunal held that the corporate veil was required to be pierced and the transactions were held to be dubious and subject to rest tax liability. Some relevant portion of para 132 and 136 are worth referring:

> *"132. Another strong contention which has been raised that merely be acquiring shares of a company shareholders would not become owners of the company and in this regard, decision of Hon'ble Supreme Court in the case of Mrs. Bacha F. Guzdar 375 vs. CIT 27 ITR 1 and also the judgment of Rustom Cawasjee Cooper vs. UOI (1970) 1 SCC 248 and Carew & Co. Ltd. vs. UOI 46 CC 121 (SC) has been relied upon. This line of argument has already been dealt by the Hon'ble Delhi High Court and*

also by the Tribunal in paragraphs noted (supra). Thus, this contention has no locus- standi in the light of the binding judicial precedents, because the ***corporate veil has been pierced*** *and the separate juridical identity of two entities has been blurred, therefore, the principle laid down in the aforesaid judgments of Hon'ble Supreme Court is not applicable to the present facts."*

*" 136……..**Once the corporate veil has been lifted and the interested parties have been found to be in collusion with each other** to give huge benefit of hundreds of crores of property to the appellant company, the only inference which can be drawn is that all which has been tried to showcase the picture was just phantasmagorical illusion and not real."*

3.05 The Supreme Court of India in the case *M.K. Rajagopalan Vs. Dr. Periasamy Palani Gounder*, 2023 INSC 486 (May 3, 2023), referred to section 88 of Indian Trust Act, 1882 in context of financial misuse or advantage taken by Director of a company or any person in fiduciary capacity. The ruling was about the importance of fiduciary capacity, in which a person cannot take any direct or indirect advantage. The para 159 of the said judgement is reproduced as under:

"159. We may further take note of Section 88 of the Trusts Act which essentially provides for nullifying the pecuniary advantage if gained by a fiduciary and ordains that where a trustee, executor, partner, agent, director of a company, legal advisor, or other person bound in a fiduciary character to protect the interests of another person, by availing himself of his character, gains for himself any pecuniary advantage; or where the person so bound enters into any dealings under circumstances in which his own interests are, or may be, adverse to those of such other person and thereby the fiduciary gains for himself a pecuniary advantage, he would hold the advantage so gained for the benefit of such other person."

3.06 In the light of the above, the share premium charged by shareholders, in lieu of the value of the net assets of the section 8 company, is a direct benefit derived by the shareholders. One may argue that such premium is the price for control of the company, and does not affect the funds designated for the beneficiaries. However, in our opinion, such transfers are certainly susceptible to further inquiry, investigation, and appropriate legal recourse.

WILL THE SHARES BE VALUED UNDER RULE 11UA OF INCOME TAX RULES

4.01 In our opinion, the shareholders of a section 8 company do not have any right on the net worth or investment of the company, therefore, such shares cannot be valued under Rule 11UA of the Income Tax Rules read with section 56(2)(x) of the Income Tax Act. However, if a transfer of share at premium, in any case, is being made then transferer of shares shall be liable for capital gains tax on the premium.

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Annexure - 1

TEXT OF SECTION 8 OF COMPANIES ACT, 2013

Formation of Companies with Charitable Objects

8.(1) Where it is proved to the satisfaction of the Central Government that a person or an association of persons proposed to be registered under this Act as a limited company—

(a) has in its objects the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object;

(b) intends to apply its profits, if any, or other income in promoting its objects; and

(c) intends to prohibit the payment of any dividend to its members, the Central Government may, by licence issued in such manner as may be prescribed, and on such conditions as it deems fit, allow that person or association of persons to be registered as a limited company under this section without the addition to its name of the word "Limited", or as the case may be, the words "Private Limited", and thereupon the Registrar shall, on application, in the prescribed form, register such person or association of persons as a company under this section.

(2) The company registered under this section shall enjoy all the privileges and be subject to all the obligations of limited companies.

(3) A firm may be a member of the company registered under this section.

(4) (i) A company registered under this section shall not alter the provisions of its memorandum or articles except with the previous approval of the Central Government.

(ii) A company registered under this section may convert itself into company of any other kind only after complying with such conditions as may be prescribed.

(5) Where it is proved to the satisfaction of the Central Government that a limited company registered under this Act or under any previous company law has been formed with any of the objects specified in clause (a) of sub-section (1) and with the restrictions and prohibitions as mentioned respectively in clauses (b) and (c) of that sub-section, it may, by licence, allow the company to be registered under this section subject to such conditions as the Central Government deems fit and to change its name by omitting the word "Limited", or as the case may be, the words "Private Limited" from its name and thereupon the Registrar shall, on application, in the prescribed form, register such company under this section and all the provisions of this section shall apply to that company.

(6) The Central Government may, by order, revoke the licence granted to a company registered under this section if the company contravenes any of the requirements of this section or any of the conditions subject to which a licence is issued or the affairs of the company are conducted fraudulently or in a manner violative of the objects of the company or prejudicial to public interest, and without prejudice to any other action against the company under this Act, direct the company to convert its status and change its name to add the word "Limited" or the words "Private Limited", as the case may be, to its name and thereupon the Registrar shall, without prejudice to any action that may be taken under sub-section (7), on application, in the prescribed form, register the company accordingly:

Provided that no such order shall be made unless the company is given a reasonable opportunity of being heard:

Provided further that a copy of every such order shall be given to the Registrar.

(7) Where a licence is revoked under sub-section (6), the Central Government may, by order, if it is satisfied that it is essential in the public interest, direct that the company be wound up under this Act or amalgamated with another company registered under this section:

Provided that no such order shall be made unless the company is given a reasonable opportunity of being heard.

(8) Where a licence is revoked under sub-section (6) and where the Central Government is satisfied that it is essential in the public interest that the company registered under this section should be amalgamated with another company registered under this section and having similar objects, then, notwithstanding anything to the contrary contained in this Act, the Central Government may, by order, provide for such amalgamation to form a single company with such constitution, properties, powers, rights, interest, authorities and privileges and with such liabilities, duties and obligations as may be specified in the order.

(9) If on the winding up or dissolution of a company registered under this section, there remains, after the satisfaction of its debts and liabilities, any asset, they may be transferred to another company registered under this section and having similar objects, subject to such conditions as the Tribunal may impose, or may be sold and proceeds thereof credited to Insolvency and Bankruptcy Fund formed under section 224 of the Insolvency and Bankruptcy Code, 2016.

(10) A company registered under this section shall amalgamate only with another company registered under this section and having similar objects.

(11) If a company makes any default in complying with any of the requirements laid down in this section, the company shall, without prejudice to any other action under the provisions of this section, be punishable with fine which shall not be less than ten lakhs rupees but which may extend to one crore rupees and the directors and every officer of the company who is in default shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to twenty-five lakh rupees

Provided that when it is proved that the affairs of the company were conducted under section 447.