

Ref. No.:  
Date:

To

**Shri Vinod Kumar I.R.S.**  
Joint Secretary (TRU-II)  
Central Board of Excise & Customs  
Ministry of Finance  
North Block  
NEW DELHI – 110001.

**Sub: Request for service tax exemption for the Chit Fund Foreman commission**

Dear Sir,

1. M/s. All India Association of Chit Funds (hereinafter AIACF or 'we') is a trade association of over 30,000 Chit Funds spread across the whole of India.

**Understanding Chit Funds**

2. Chit Funds<sup>1</sup> is a traditional Indian equivalent of the Rotating Savings and Credit Associations throughout the world, which are a flexible means both to save and borrow simultaneously. Chit Funds are classified as Miscellaneous Non-Banking Financial Institutions and are governed by Central Chit Fund Act, 1982, administered by State Governments<sup>2</sup> with an advisory role assigned to the Reserve Bank of India.
3. Chit Fund industry in India is estimated at over Rs. 35,000 crore. Research shows that the percentage of household participating in chit funds is between 5-10% of the total household population in each state (except Delhi). Money circulated via chits is around Rs. 50,000 per household on an average (except Kerala). Moreover, Chit Funds significantly contribute to financial inclusion given the fact that more than 50% of the Chit Fund subscribers earn less than USD 1.25 per day<sup>3</sup> (Refer SEFC-IFMR Research Report enclosed as **Annex-1**). Chit Funds are considered as one of the best instruments to

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<sup>1</sup> Refer – Note 1 in Notes to Representation

<sup>2</sup> Refer – Note 2 in Notes to Representation

<sup>3</sup> Refer – Note 3 in Notes to Representation

cater the needs of low income households in India<sup>4</sup>. It is relevant to mention that more than 50% of chit fund companies are below the Service Tax threshold.

4. Chit Funds are a highly regulated industry<sup>5</sup> with 96% of the subscribers perceiving their investments with Chit Funds to be safe or very safe.

#### **Reasons for investments in Chit Funds**

5. The primary *ex-ante* reasons for participation in Chit Funds are savings (72.1%<sup>6</sup>), raise capital for personal consumption (25.9%) and invest in working capital (20.9%). The primary *ex-post* reasons for bidding in a given month is emergency needs (55.9%), business investment (30.0%), to purchase household goods (23.3%) and to fund working capital needs (14.5%). A study shows that women subscribers usually bid to meet marriage expenses either their own or their family members and men usually bid when there is a requirement in their business<sup>7</sup>.

#### **Manner of working of Chit Funds**

6. Briefly stated, the chit amount collected for a month (known as Pot) is auctioned and offered to the bidder-member who offers the highest 'discount'. Out of this discount the foreman retains some amount as remuneration and for meeting expenses of chit (for short referred to as 'commission' by convention) and distributes the balance discount to the members. It may be noted that it is the Chit Foreman who bears the risk of delay and default in payments by the members and hence the name 'commission' for his remuneration is actually a misnomer. There is no commission being charged by the Foreman from the members for providing any service as such.
7. In fact, the ledger account of each member (illustrative copies enclosed as **Annex-2**) reflects the sum value payable by the member for a month as only the chit value after deducting the proportionate amount of discount after adjustment for the commission (referred to as the 'dividend'). The members are not the recipient of any service from the Foreman as there is no consideration flowing from them to the foreman and the adjustment for the commission amount from the discount is an in-built mechanism for running of chit. The account books of the members do not show any commission paid or payable to the Chit Foreman. Only the actual payments made to the chit fund company and the prize amount received from the Chit Fund are shown.

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<sup>4</sup> Refer – Note 4 in Notes to Representation

<sup>5</sup> Refer – Note 5 in Notes to Representation

<sup>6</sup> Refer – Note 6 in Notes to Representation

<sup>7</sup> Refer – Note 7 in Notes to Representation

8. Thus the remuneration received by the Foreman for running of chit funds (though also referred to as commission by convention) cannot be treated at par with or compared with 'commission' received by Real Estate Brokers, Lottery Agents, Selling agents, etc. for their agency services.

#### **Returns from Chit Funds**

9. Interest/Discount rates or rate of returns for Chit Funds are not determined *ex-ante*. However, analysis of the bidding data shows that the Internal Rate of Return (IRR) based on cash flows determined on *ex-post* basis could range around 6-10% p.a. and generally compares only with returns from savings instruments of similar tenor and liquidity of banks and other non-banking financial companies (NBFCs).

#### **Chit Funds – A Boon to Small Enterprises and lifeline to low income households**

10. But as already seen, Chit Funds majorly cater to low income households and it is the other in-built advantages, viz., easy accessibility, user friendly services, etc., free of latent cost and periodic interest hikes, or pre-closure charges, which primarily make them attractive to the Chit Fund subscribers.
11. **A recent NSSO study** on unincorporated non-agricultural enterprises during July 2010 – June 2011 which categorizes the various sectors in terms of their contribution to GDP states that despite generating a value addition of Rs.6.28 lac crore per annum, less than 4% of this sector's financial needs are served by banks! **As it further rightly emphasizes that it is in the national interest to nurture this sector, one question that arise is, what better tool than Chit Funds.**

#### **Additional burden will push Chits into informal channels**

12. As regards the return for the Chit Foreman, it will be relevant to mention that, but for the late payment charges and interest collected on the security deposit, it may not be even possible for most Foremen to break even.
13. In fact, notwithstanding their contribution to financial inclusion, there has been a trend in the last decade in terms of decrease in number of Chit Fund companies and schemes being registered. A major reason for this trend is the changes in regulation and tax structure which makes it more expensive for the Chit Fund companies to serve the poor. Increased taxation in the form of service tax will make the Chit Funds unviable and/or reduce the returns to the members. This will only push the lower value schemes into the unregistered Chit Funds where the investments are less secure.

### **Budget 2015-16 changes in service tax on Chit Funds**

14. It may be recalled that the Hon'ble Delhi High Court recently examined<sup>8</sup> the question of whether the services rendered in connection with a chit business are leviable to service tax or not and came to the conclusion that no service tax is chargeable on the services rendered by the foreman in a business chit fund.
15. However, in Budget 2015-16, the Government of India has sought to undo this judicial decision by amending the definition of 'service' to effectively include the activity carried out by a foreman of chit fund for conducting or organizing a chit in any manner within its scope<sup>9</sup> (extracts from Finance Act, 2015 and relevant notification enclosed as **Annex-3**). In effect, the services provided by chit fund foremen by way of conducting a chit will now be leviable to service tax.
16. Moreover, the Government has withdrawn the abatement (of 30% subject to no Cenvat credit being taken in respect of inputs, input services or capital goods)<sup>10</sup> available to services provided in relation to Chit Fund, without any specific reason being cited for such withdrawal<sup>11</sup>.
17. The effect of these Budget 2015-16 changes is that the Chit Fund companies shall now pay service tax on the foreman commission on the full consideration without any option for availing any abatement facility. Given the cap imposed by the Chit Funds Act on the Foreman Commission, this will become an additional cost on the Chit Fund companies. The likely impact is that the viability of Chit Funds would be seriously affected which in turn would adversely impact the lower strata of society who save or finance their funding requirements through Chit Funds.

### **Request for level playing field between Chit Funds and Banks/NBFCs**

18. It is clear that Chit Funds are Non-banking Financial Companies (NBFC) under RBI regulations. The functionality of the chit funds is akin to the Banks and NBFCs who mobilize the savings from account holders and lend the same to borrowers. The spread

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<sup>8</sup> *Delhi Chit Fund Association v. Union of India* [2013 (30) STR 347 (Del)]. Appeal preferred by the Union of India to the Hon'ble Supreme Court stands dismissed. The Hon'ble Andhra Pradesh High Court, in its order dated 12.11.2013 in WP No. 26715 of 2012, has drawn reference to the said Delhi High Court judgment and have held that "the judgment of the Delhi High Court will be operating in the field unless and of course the same has not been upset or set aside by the Hon'ble Supreme Court".

<sup>9</sup> *Explanation-2* to section 65B(44) of the Finance Act, 1994 has been amended *vide* section 107 of the Finance Act, 2015, to explicitly clarify that 'transaction in money' for the purpose of exclusion from the definition of 'service' shall not include the activity carried out by a foreman of chit fund for conducting or organizing a chit in any manner. The amendment has come into effect from 14.05.2015.

<sup>10</sup> *Vide* S.No. 8 of notification No. 26/2012-ST, dated 20.06.2012.

<sup>11</sup> Refer para 9.3 of JS(TRU)-II's letter F.No. 334/5/2015-TRU, dated 28.02.2015 discussing the changes made in service tax in Union Budget 2015-16. The amendment is effective from 01.04.2015.

between the interest rate on the deposits and the lending rate is the earning of banks/NBFCs which is used for administration/working of the banks.

19. In essence, the position of Chit Funds (or Foreman) is no different from a banker/NBFC wherein the Foreman plays a similar kind of role as of a bank/NBFC in relation to Chit Funds. The Foreman remains responsible for the amount due to each member of the Chit Fund<sup>12</sup> in the same manner as the banker is to each of its account holders.
20. Accordingly, it is submitted that the Foreman Commission would warrant a similar tax treatment as of the spread earned by banks/NBFCs. It may be taken note that the spread earned by the banks are not chargeable to service tax. Hence merely taxing the spread earned by the Foreman (i.e. Foreman Commission) would lead to a differential tax treatment thereby making the Chit Funds unviable.
21. Globally also the service of financial intermediation have been regarded as exempt from the levy of VAT/GST. The common reason for non-taxing the financial intermediation service is owing to difficulty in identification of the value-addition in such services which is hidden between the spread between interest rate of deposit and lending. For instance, under Recast VAT Directive of European Union, the financial and banking services have been kept under exemption (Reference Article 135). Similarly, in Australian GST also, the financial supplies are treated as input-taxed (i.e. on which no output tax is charged).
22. Without prejudice to above, even if the transaction of commission retained by foreman is sought to be taxed, the same may be taxed as the other NBFC's are being taxed (on 10% of the value of consideration). This would at least maintain a level playing field amongst the Chit Funds and other NBFCs whose roles and risks are similar.

### **PRAYER**

23. In view of the above, it is most respectfully prayed that -
  - a) The Chit Fund Foreman commission may be exempted from service tax;
  - b) Alternatively, such amount may be taxed at an abated value of 10% of the Chit Fund Foreman commission like in the case of other NBFC's in order to maintain a level playing field.
24. In case any further information is necessary, please let us know and we shall be glad to provide the same.

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<sup>12</sup> Refer Section 25(1) of the Chit Funds Act

25. We also request for an opportunity to make a representation in the matter in person.

Thanking you,  
Yours sincerely,  
For **All India Chit Funds Association**

Authorised Signatory

Encl: **Annex-1 to 3** (as above)

Copy submitted to:

1. The Revenue Secretary, Department of Revenue, North Block, New Delhi.
2. The Chairman, Central Board of Excise and Customs, Department of Revenue, North Block, New Delhi.
3. Shri S.M. Tata, I.R.S., Commissioner of Service Tax, Central Board of Excise and Customs Department of Revenue, North Block, New Delhi.

## Notes to Representation

### Note 1:

Chit Funds Act applies to all chits except those commenced before the Act and any chit the aggregate amount of which does not exceed Rs.100. All other chits have to adhere to the provisions of the Chit Funds Act 1982

### Note 2:

SEFC-IFMR Research: “**Chit Funds as an Innovative Access to Finance for Low-Income Households**” (Prepared by Ms. Preethi Rao & Ms. Sharon Buteau under the guidance of Prof Mudit Kapoor, ISB Hyderabad, India & Prof Antoinette Schoar, MIT Sloan of Management, USA. (pps. 33 and 58)

### Note 3:

This industry accounts for a lion’s share of credit to the rural masses and provides direct and indirect employment to millions giving impetus to GDP growth. **Dr. Babatosh Dutta Committee, Dr. A.C. Shah committee** have lauded chit funds for the role in our economy. In the findings of **James Raj Committee** based on whose report the 1982 Act was enacted, Chapter 6 Para 13 “.... *The rationale of chit funds is that they bring the borrowing class directly in contact with the lending class...*”

### Note 4:

Besides other restrictions, Section 21(b) of the Chit Funds Act, 1982 also imposes a cap of 5% of the chit amount on the foreman’s commission or remuneration or the amount chargeable by him for meeting the expenses of running the chit.

### Note 5:

Percentage of the total number of Chit Fund subscribers.

### Note 6:

**Males constitute 83.1% and females constitute 16.6% of the Chit Fund subscribers.** For details refer SEFC-IFMR Research: “**Chit Funds as an Innovative Access to Finance for Low-Income Households**”, (Prepared by Ms. Preethi Rao & Ms. Sharon Buteau under the guidance of Prof Mudit Kapoor, ISB Hyderabad, India & Prof Antoinette Schoar, MIT Sloan of Management, USA.*supra*, (pp. 41)