

## Chit Funds - A Tax & Regulatory Perspective

Nov 11, 2021



### Wrutuja Soni

Assistant Manager, KNAV India



### Raj Maniyar

Associate, KNAV India

A 'chit' defined under Chit Fund Act, 1982 ('Chit Act') means a transaction by or under which a person enters into an agreement with a number of persons that every one of them shall subscribe a certain sum of money by way of periodical instalments over a definite period and that each subscriber shall, in his turn, as it determines by lot, or by auction, or in such other manner as may be in the chit agreement, be entitled to the prize amount. A chit fund, therefore, in common parlance is a savings and borrowing system wherein a group of people come together and pool their resources and then bid for the total sum contributed by all the parties. The duration of the chit fund (in months) generally equals the number of subscribers to the fund. Each bidder is required to contribute a certain amount of money every month and in most of the cases, the winner is decided by way of a lottery. So, the winner gets a certain amount of money from the chit fund which can be used by the bidder to meet his requirements. Suppose for e.g., the bidder pools in INR 30,000/- in the fund and receives INR 35,000/- by winning the bid for a particular month. Amount of INR 5,000/- received by such bidder in excess would generally be his profit (considered mostly as 'dividend') and if the amount received is INR 25,000, then the shortfall of INR 5,000 would be his loss.

## I. REGULATION OF CHIT FUNDS IN INDIA AND BENEFITS PROVIDED BY THEM

Chit fund business in India is regulated under the Chit Act. However, chits of various states are regulated as per the respective Acts for e.g., chit fund schemes in Tamil Nadu are regulated by the Madras Chit Funds Act, 1961. The same has been extended to Delhi as well. However, for the sake of brevity, regulation as per the Chit Act is only considered.

### A. REGISTRATION AND OTHER CONDITIONS FOR RUNNING CHIT BUSINESS

As per the Chit Act, no chit should be commenced or conducted without obtaining the previous sanction of the State Government within whose jurisdiction the chit is to be commenced or conducted. An application for registration of the chit shall be made by the foreman<sup>[1]</sup> in such form and manner as may be prescribed.

Per section 8 of the Chit Act, notwithstanding anything contained in the Companies Act, 1956 (now 2013), but subject to the provisions of the Chit Act, a Company shall commence or carry on chit business only if it has a paid-up capital of not less than INR 1 lakh. Further, the company shall create and maintain

a reserve fund and out of the balance of profit of each year as disclosed in its profit and loss account and before any dividend on its share is declared, transfer a sum of not less than ten percent of such profit to the reserve fund. Further, as per section 12 of the Chit Act, the Company should not be engaged in business other than that of carrying on the chit business.

Per FAQs on NBFCs<sup>[2]</sup>, a chit business must be registered as a Non-Banking Financial Company ('NBFC'). However, such NBFCs are not required to register themselves with RBI under section 45-IA of the Reserve Bank of India Act, 1934 ('RBI Act') and hence such businesses are not subject to the stringent regulations which are applicable to the companies registered under Sec 45-IA of the Act. Further as per section 45 I(bb) of the RBI Act, amount received by way of subscriptions by Chit fund companies are not deposits and hence chit fund companies are specifically prohibited by RBI from accepting deposits.

## **B. MINUTES, BOOKS OF ACCOUNTS AND AUDIT OF FINANCIAL STATEMENTS**

Per section 18 of the Chit Act, a true copy of the minutes of the proceedings of every draw certified as such by the foreman shall be filed by the foreman with the Registrar within twenty-one days from the date of the draw to which it relates.

Further, per section 23 of the Chit Act, the foreman is required to maintain a register at the registered office of the company or any place of business for the conduct of chit business, a register should contain details of names and particulars of each subscriber, dates on which chit agreements were signed by subscribers, proceedings of minutes, a ledger containing (a) amounts paid by subscribers in each chit along with date of payment (b) amounts paid to prized subscribers along with dates of payment, etc.

Moreover, per section 24 of the Chit Act, balance sheet as on the last date of each calendar year, or, as the case may be, financial year of the foreman, and a profit and loss account relating to the year of account should be prepared and the same should be audited by auditors qualified to act as auditors under the Companies Act, 2013, or by a chit auditor appointed under section 61 of the Chit Act.

## **C. IMPACT OF 'THE BANNING OF UNREGULATED DEPOSIT SCHEMES ACT, 2019' AND 'THE PRIZE CHITS AND MONEY CIRCULATION SCHEMES (BANNING) ACT, 1978 ON CHIT FUNDS REGISTERED UNDER THE CHIT ACT**

As per Section 3 of 'The Banning of Unregulated Deposit Schemes Act, 2019' ("2019 Banning Act"), on and from the date of commencement of the Act, all unregulated deposit schemes would be banned and promotion, operation, solicitation for acceptance of such unregulated deposits directly or indirectly by any deposit taker would also be prohibited. As per Sec 6 of the 2019 Banning Act, any prize chit or money circulation scheme banned under the provisions of 'The Prize Chits and Money Circulation Scheme (Banning) Act, 1978 ("1978 Banning Act") shall be deemed to be an Unregulated deposit scheme under the 2019 Banning Act. Sec 2(14) of the 2019 Banning Act defines 'Regulated Deposit Scheme' as schemes specified under column (3) of the First Schedule. It covers any scheme or arrangement commenced or conducted as a chit business with the previous sanction of the State Government in accordance with the provisions of the Chit Act. It also further covers any scheme or arrangement covered by Sec 11 of the erstwhile 1978 Banning Act which provides for non-applicability of the said Act to prize chits or money circulation schemes promoted by State Governments or any officer or authority on its behalf or a company wholly owned by a State Government which does not carry on any business other than that of conducting a prize chit or money circulation scheme.

Therefore, a conclusion can be reached upon that chits accepted by companies registered under the Chit Act **are not be banned** from carrying on the business of chit funds. Further, the same view can be confirmed by per section 45 I(bb) of the RBI Act which states that amount received by way of subscriptions by Chit fund companies are **not deposits and hence not covered** by the 2019 Banning Act.

These are some of the relevant regulatory aspects as far as regulation of chit funds is concerned.

## **II. TAXABILITY OF CHIT FUNDS**

### **ENTITIES ENGAGED IN THE CHIT BUSINESS**

Entities engaged in the business of chit funds operate chit fund schemes with registration under the relevant Chit Fund Act. They generally provide the following services –

- Floating a chit fund scheme
- Finding potential members and enrolling members into a chit
- Collecting contributions
- Conducting chit auctions
- Distributing funds and maintaining books.

Such entities earn a fixed amount of the members' contribution to operate the chit fund scheme. Various aspects as per the Income tax Act, 1961 ("the Act") applicable to Chit fund companies are discussed hereunder:

#### **A. ALLOWABILITY OF EXPENSES:**

As such, the entities on their own do not pool in own money into the chit fund business and hence, they are not exposed to any loss on account of a certain member defaulting on payment of money which he had won in the chit auction ('prized member'). However, in cases where a prized member defaults in his instalments, it may invite litigation and the entities may have to make good the loss on account of such default. In such a case, a question may arise as to whether the default made by the prized subscriber can be treated as 'bad debts' and a deduction can be claimed for the amount of loss made good by the entities.

The view taken by the Appellate authorities was generally against the taxpayer for allowability of deduction for the amount of loss made good.

In **Soda Silicate and Chemical Works**<sup>[3]</sup>, the Hon'ble Punjab and Haryana High Court, while disallowing the claim of the assessee for discount on subscribing to the chit fund, held that neither a claim for expense from the taxpayer nor a claim for addition of income by the revenue department can be made in cases where a group of people come together and contribute to the chit funds because engaging in the contribution to chit fund of money was not the business of the assessee and there was **clearly a case of mutuality** amongst the contributors and the participants of the chit funds with their identity being known and established and hence, as the concept of mutuality applies, a person cannot be expected to make profit out of himself and hence neither expense would be allowable and neither income would be taxable. Hence, the claim of assessee for discount as an expense was disallowed. In this case, Instruction no.1175 issued by the CBDT under order F. No. 169/21/78-IT (80) dated May 16, 1978 was not taken into consideration and business loss was disallowed. The gist of CBDT Instruction no.1175 is as follows:

(a) If any person organizes chit funds and for these purposes brings the members together, administers the Chit Funds and thereby earns commission, etc., profit made by such a person is income from his business and if for any special reason there is a loss then it is business loss. Normally there should be no loss to the organizer unless he takes over the liability of some of the members. In such a case, the unrecovered amount due from such members will have to be treated as bad debts and the test to be adopted is usual business assessment for the allowance of bad debts would be applicable in such cases also.

(b) In the hands of the subscribers, a few will be receiving more than what they have subscribed. This extra amount is in the nature of interest and as such, taxable. Members who take the money earlier from the chit will necessarily have to contribute more which means that they incur loss, which is nothing but interest taken for moneys taken in advance. The claim for such a loss will have to be considered for the purpose of allowance according to the provisions of the Act depending upon how the money was utilized by the subscriber.

Based on this decision, several other decisions relating to chit business were re-opened under section

263 of the Act and claims for loss were disallowed. As a result of subsequent re-opening of assessments on these grounds, a clarification was issued by CBDT on 25th March, 1992 directing that CBDT Instruction no.1175 cannot be withdrawn based on the decision of the case of Soda Silicate and the said instruction stood as it is.

Hence, a view can be taken that such expenses can be claimed as bad debts / discount by the assessee engaged in the chit fund business by relying upon CBDT Instruction no.1175.

## **B. DEDUCTION OF TAX AT SOURCE IN CASE OF DISCOUNT / INTEREST PAID BY CHIT FUND TO ITS MEMBERS:**

The member paying the highest bid money is entitled to take the chit. This amount of bid offered by him is equally distributed by the chit fund company to all the members. In the case of **Sahib Chits (Delhi) Pvt. Ltd.** [4], it was held by the learned Assessing Officer ('AO') that amount in the form of discount disbursed to members / subscribers of chit funds was 'interest' and hence assessee had defaulted by not deducting tax at source at the time of disbursement under section 194A of the Act and hence should be considered an assessee-in-default as per section 201(1) of the Act and liable to pay interest as per section 201(1A) of the Act. However, the Honorable Delhi High Court held that discount disbursed by chit fund companies to its members was 'not interest as per Sec 2(28A)' as the same was neither payable in respect of moneys borrowed nor any debt incurred by the chit fund companies from its members. This view was confirmed by the ruling of the Honorable Supreme Court in the case of **Shriram Chits Investment Pvt. Ltd. vs Union of India AIR 1993 SC 2063** wherein the court relied on the judgment of the Kerala High Court in **Janardhana Mallan vs Gangadharan AIR 1983 Ker 178 (FB)**, wherein it was held that on entering into the chit agreement a debt is not incurred by the subscriber for the amount of all the future instalments and in respect of such amount there is no debtor-creditor relationship.

Hence, no tax is required to be deducted in cases of payment of interest / discount by the chit fund companies to its members / subscribers.

## **METHOD OF ACCOUNTING FOLLOWED AND RECOGNITION OF INCOME AND EXPENSE IN BOOKS OF ACCOUNTS:**

In the case of **Bilahari Investments Pvt. Ltd.** [5], the assessee was following mercantile system of accounting and accordingly used 'Completed contract method' for recognition of revenue and expenditure. During the year under consideration, the AO held that 'deferred revenue expenditure' method would be more suitable and hence computed profits by applying the same. The dispute was regarding dividend and discount being recognized in the year in which the relevant chit fund is terminated. It was held by the Hon'ble Madras High Court that where Revenue had not objected to method of accounting in earlier years, the same cannot be done now unless revenue can prove that such method led to distortion of profits. However, the Hon'ble Court held that since the assessee was following mercantile basis of accounting, dividend ought to be recognized in the books of accounts as and when it accrued and not at the time of completion / termination of the relevant chit. Having said that, it was held that discount was correctly accounted in the year of completion of the chit fund. Further, the Hon'ble Court relied on the section 3 of the Chit Act and held that the same being a non-obstante clause, definitions as provided in the Chit Act would prevail over the other definitions and accordingly, discount was not interest payable on the prized amount, but a loss. The Hon'ble Supreme Court dismissed the appeal of the Revenue on the same lines [6]. In the light of above, it can be said that the assessee can follow any method of accounting provided it depicts a correct picture of the income and expenses of the Chit fund.

## **Allowability of business expense and treatment as dividend income in the hands of assessee bidding for chits (in case of bids raised for business purposes)**

a. In **Kovur Textiles and Co.** [7], it was held that loss claimed by the assessee only for the purposes of financing the business was to be held as an allowable expenditure and hence loss could be claimed by the assessee.

b. In **Kamal Raheja** [8], the Tribunal while relying on *Kovur Textiles and Co.*, held that if a subscriber incurs loss in subscribing to chit funds to raise funds to use them in his business or profession, such a

loss is an allowable deduction. Reliance was further placed on Instruction no.1175 issued by the CBDT under order F. No. 169/21/78-IT (80) dated May 16, 1978.

Hence, a conclusion can be drawn from aforesaid jurisprudence as well as basis CBDT Instruction no.1175 that when bids have been made by the assessee for the purpose of raising funds to be used for business or profession and even if bidding for chits is not the business activity of the assessee, the same would be allowed as deduction in the case of loss incurred on account of such chit business.

### **Treatment in cases where bids are raised for personal savings and investment purposes**

In cases where the bids are raised for savings and investment purposes, excess amount received ('dividend') would be treated as 'Income from other sources' and loss if any would be allowed as an expense from dividend earned while bidding for chits.

### **CONCLUSION**

Chit funds although regulated by various regulations, provisions of Chit Act are much less stringent as compared to other entities like banks. On account of this, it becomes easier to have access to funds without much hassle and various compliances to be undertaken. Chit fund can help individuals and businesses with easier access to funds provided they are the highest bidders. The tax aspect of chit funds is important to such businesses who raise funds through chit activities as it can be difficult for them to prove whether funds from bidding were used for business purposes or for personal purposes. This should be demonstrated well to the revenue authorities, and one should maintain proper and adequate documentation to prove the fact.

---

[1] 'Foreman' means the person who under the chit agreement is responsible for the conduct of the chit.

[2] ['All you wanted to know about NBFCs' dated 10/01/2017](#)

[3] [\[TS-5375-HC-1989\(PUNJAB\)-O\]](#)

[4] [\[TS-5586-HC-2009\(DELHI\)-O\]](#)

[5] [\[TS-5911-HC-2006\(MADRAS\)-O\]](#)

[6] [\[TS-49-SC-2008-O\]](#)

[7] [\[TS-5080-HC-1980\(ANDHRA PRADESH\)-O\]](#)

[8] [\[TS-6738-ITAT-2016\(LUCKNOW\)-O\]](#)