

TAX INCENTIVES IN SPECIAL ECONOMIC ZONES

By

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ABSTRACT

In several states in India, specific areas - large and small, rural and urban, are being identified as special economic zones (SEZ's) to carry out modern hi-tech corporatised activities with promised returns at a high rate. The SEZs are tax-free enclaves for investors from India and abroad. In terminology of Taxation, trying to understand Special economic Zones, they are generally, designated duty free enclaves which are considered as deemed foreign territories for the purpose of trade operations, duties, and tariffs. Several exemptions and concessions to SEZ developers and SEZ units from various taxes and duties have been granted by the government with a view to boost exports and investments.

The special feature about SEZ is special economic system and policy where special tax incentives for foreign investment in SEZ and greater independence on international trade activities are provided. In India there are 588 SEZ's which are recognised under the Ministry of Commerce and Industry. In toto there are 948 units which are in operation in the SEZs, providing direct employment to about 1.10 lakhs persons (about 40% of them are women). Private investment by entrepreneurs for establishing units in the SEZs is about Rs. 2000 crores.

INTRODUCTION

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¹ 5th year, DSNU, Vizag

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Salient features of SEZ⁵ are:-

- i. A designated duty free enclave to be treated as foreign territory only for trade operations and duties and tariffs.
- ii. No licence required for import.
- iii. Manufacturing, trading or service activities allowed.
- iv. SEZ units to be positive net foreign exchange earner within three years.
- v. Domestic sales subject to full customs duty and import policy in force.
- vi. Full freedom for subcontracting.
- vii. Duty-free goods to be utilised over the approval period of 5 years.
- viii. No routine examination by customs authorities of export/import cargo.
- ix. Minimum size of multi-product SEZ, not to be less than 1000 hectares.

The Special Economic Zones (SEZ) Bill 2005 became an Act on June 23rd, 2005. It was aimed at "Establishment, Development and Management of SEZs for promotion of exports and for matters connected therewith or incidental thereto".

Administrative set up for SEZs:

The functioning of the SEZs is governed by a three tier administrative set up –

- (i) The Board of Approval is the apex body in the Department,

³TanujBhushan and Aparna Sharma, Special Economic Zones in India, [2007] 80 SCL 103 (MAG)

⁴<http://www.sezindia.nic.in/index.asp> last visited on 24/03/2013

⁵<http://commerce.nic.in/annual2005-06/englishhtml/ch-6.htm> last visted on 24/03/2013

- (ii) The Unit Approval Committee at the zonal level dealing with approval of units in the SEZs and other related issues, and
- (iii) Each Zone is headed by a Development Commissioner, who is also heading the Unit Approval Committee.

The performances of the SEZ units are monitored annually by the Unit Approval Committee and units are liable for penal action under the provision of Foreign Trade (Development and Regulation) Act, in case of violation of the conditions of the approval.

INCENTIVES AND FACILITIES OFFERED TO THE SEZS

Direct Incentives⁶

- a. Deduction of export profits to unit commencing manufacturing or producing articles or things or unit which start providing services from April 1, 2005.
- b. Exemption from capital gains arising on transfer of assets on shifting of industrial undertaking from urban area to any SEZ.
- c. Exemption from VAT on income accruing or arising on or after April 1, 2005 from business carried on or services rendered.
- d. No tax payable on interest received by non-residents and not-ordinary residents on deposits made with an Offshore Banking Units (OBU) in SEZ on or after April 1, 2005.

Indirect Incentives

The incentives and facilities offered to the units in SEZs for attracting investments into the SEZs, including **FOREIGN INVESTMENT** include:-

- a. Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units
- b. 100% Income Tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for next 5 years.
- c. Exemption from minimum alternate tax⁷.

⁶VivekSadhale, Special Economic Zones, [2006] 6 CAT 202

⁷section 115JB of the Income Tax Act

- d. External commercial borrowing by SEZ units upto US \$ 500 million in a year without any maturity restriction through recognized banking channels.
- e. Exemption from Central Sales Tax.
- f. Exemption from Service Tax.
- g. Single window clearance for Central and State level approvals.
- h. Exemption from State sales tax and other levies as extended by the respective State Governments.

The major incentives and facilities available to **SEZ DEVELOPERS** include:-

- a. Exemption from customs for goods imported or exported from a SEZ which is useful for the development of SEZs for authorized operations approved by the Board of Approval under provisions of Customs Act, 1962⁸.
- b. Exemption Excise duties for development of SEZs for authorized operations approved by the Board of Approval under provisions of Excise Act, 1944⁹.
- c. Income Tax exemption on income derived from the business of development of the SEZ in a block of 10 years in 15 years¹⁰.
- d. Exemption from minimum alternate tax¹¹.
- e. Exemption from dividend distribution tax¹².
- f. Exemption from Central Sales Tax (CST).
- g. Exemption from Service Tax¹³.

INCENTIVES UNDER INCOME TAX

The matters relating to SEZ come under the jurisdiction of the Commerce Ministry. Income tax incentives for SEZ operations are provided for in the SEZ Act itself through the Second Schedule to the SEZ Act.

Section 27 of the SEZ Act provides that:

- Provisions of Income tax Act;
- As in force for time being;

⁸ Section 26(1)(a)&(b) of the SEZ Act, 2005

⁹ Section 26(1)(c) of the SEZ Act, 2005

¹⁰ Section 80-IAB of the Income Tax Act

¹¹ Section 115 JB of the Income Tax Act

¹² Section 115O of the Income Tax Act

¹³ Section 7, 26 and Second Schedule of the SEZ Act

- Shall apply to developer or entrepreneur;
- For carrying on authorised operations in an SEZ or Unit;

Section 10AA of Income Tax Act:-

Under the provisions of Income Tax Act, 1961, Section 10AA of the Act prescribes certain deductions to be made to the **ENTREPRENEUR** which is located in an SEZ location. In calculating deductions, the following conditions needed to be satisfied, They are:-

- A Deduction is allowed in computing the Total Income of the Entrepreneur;
- The Entrepreneur shall begin to manufacture or produce articles or things or providing services during previous year relevant to Assessment Year commencing on or after 01.04.2006;
- Unlike Sections 10A, 10B and 80IB, the benefit of Section 10AA extends to even service sector;
- The Deduction would be as follows:
 - (i) 100% for first 5 consecutive years;
 - (ii) 50% for next 5 years;
 - (iii) 50% for next 5 years with a condition of creation of SEZ Reinvestment Reserve Account;
- Conditions relating to utilisation of sums lying in SEZ RR Account are provided on the same lines as Section 10A(1B) and (1C).

Exception:-

1. Where a Unit had already availed for 10 consecutive years, deduction under Section 10A before commencement of SEZ Act, such a Unit is not entitled to the benefit of Section 10AA.
2. Where an SEZ Unit entitled to deduction under Section 10 AA is transferred in a Scheme amalgamation or de-merger, only the Amalgamated Company or Resulting Company will get the benefit of this Section.

Section 80IAB of Income Tax Act:-

This section deals with deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone.

- (i) Deduction under this section applies only to Developer of SEZ;
- (ii) This Section provides for a Deduction of 100% of Profits derived from business of Development of SEZ;
- (iii) The Deduction is available for 10 consecutive years;
- (iv) The Assessee may opt for any 10 consecutive Assessment Years out of 15 Years beginning with the year in which SEZ has been notified by the Central Government;
- (v) If a Developer transfers the operations & maintenance of SEZ to another Developer, the Transferee Developer gets the Deduction for remaining period.

INCENTIVES UNDER CENTRAL SALES TAX, 1956

Any inter-state sale of goods made by a dealer to a registered dealer for the purpose of setting up, operation, maintenance, manufacture, trading, production, processing, assembling, repairing, reconditioning, re-engineering, packaging or for use as packing material or packing accessories in a unit located in any Special Economic Zone or for development, operation and maintenance of SEZ by developer is exempted from CST¹⁴.

The above benefit is only available if such registered dealer has been authorised to establish such unit or to develop, and maintain such Special Economic Zone by the authority specified by the Central Government in this behalf.

INCENTIVES UNDER LOCAL SALES TAX/ VALUE ADDED TAX LAWS

Section 50 of the SEZ Act vests power with the State Government to issue notifications granting exemption from the State taxes, levies and duties to developer or entrepreneur.

The SEZ Act and the Rule provide for involvement of the State Government with clear indication of incentives offered under State fiscal laws.

¹⁴ Section 8 (6) of the Central Sales Tax Act, 1956

INTENCIVES UNDER SERVICE TAX

Taxable services provided to SEZ units or to SEZ developers are fully exempt from service tax¹⁵. But certain conditions needed to be fulfilled to avail this benefit. One of the conditions is that, to avail service tax exception it is necessary that the service so provided should be consumed within the SEZ. If any service is consumed outside the SEZ, then such services are not exempted from Service Tax. For Example, rent-a-cab service or transport service provided to employees of SEZ to bring employees to and from place of work would not be entitled to exemption from service tax since the said service is partly provided outside the SEZ¹⁶.

Section 26(1)(e) of the SEZ act provides exemption to SEZ developers and units from Service tax¹⁷.

OVERRIDING EFFECT

The SEZ Act has an overriding effect. Under the provisions of the act¹⁸, any law/ bylaw which is inconsistent with any provisions of this act, it (SEZ Act) shall have an overriding effect on any other law.

INTERPRETATION CLAUSE

In cases of Nathi Devi vs. Radha Devi Gupta¹⁹ and in Prakash Kumar vs. State of Gujarat²⁰, the Apex Court held that if there exists some ambiguity in the language or the same is capable of two interpretations, it is trite that the interpretation which serves the object and purpose of the statute must be adopted. In such cases, the Court went on say that, Doctrine of purposive construction principle should applied.

According to the rule of purposive construction, interpretation of statute should be done having regard to the purpose of the statute. This rule was first introduced by Lord Denning. So the provisions of SEZ Act, hence should be interpreted according to the rule of purposive interpretation in order to fulfil the objectives of these legislations.

¹⁵Section 93 of the Finance Act, notification No. 4/2004.

¹⁶<http://www.slideshare.net/mf23/special-economic-zones-service-tax-issues-implications> last visited on 23/3/2013

¹⁷ Also under Chapter V of the Finance Act, 1994

¹⁸Section 51 of the SEZ Act.

¹⁹ AIR 2005 SC 648

²⁰ AIR 2005 SC 1075

In Messrs Oblum Electrical Industrial vs. Collector of Customs Bombay²¹, the Supreme Court has taken the view that the wording of exemption notification have to be construed keeping in view the object and purpose of the exemption and an exemption notification cannot be read in a narrow manner so as to defeat the object of the notification.

The statute granting incentives for promoting growth and development, the Supreme Court in Vadilal Chemicals vs. State of Andhra Pradesh²², held that such statutes shall be construed liberally. It went on to say that the real object of such encouragement shall not be taken away or it should not get frustrated.

In case of CC vs. Shefali Arts²³, it was held that if a notification was made with regard to exemption from duty subject to imported machine being used for the purpose of export, it was held that exemption is available even if a part of production was sold locally, since the words exclusively, only or entirely were not used in the notification. Hence in this case also the court interpreted the words in the notification liberally. It was given a wider meaning so as the object of giving intensives are not avoided.

CONCLUSION

The SEZ Act provides the right combination of facilities and encourages setting up of world-class infrastructure for attracting FDI. The units in SEZ are entitled for income-tax exemption for 15 years 100 per cent exemption for first five years, 50 per cent for next five, and then in the next five years. The income ploughed back for investment in the capital goods is exempt up to 50 per cent. SEZ developers are also entitled to exemption from tax for 10 years.

While the SEZ Act and SEZ Rules are steps in the right direction aimed at providing a momentum to growth in exports and employment, it is essential that the tax incentives provided for in the SEZ Act are fine-tuned with the present scheme of taxation.

²¹ 1997 INDLAW SC 2746

²² [2005] 142 STC 76 (SC)

²³ 1999 (114) ELT 928 (Trib.)

