

# Special Economic Zone and Tax Incentives

**The SEZ Act has been enacted for the Establishment, Development and Management of SEZs for the promotion of exports and for matters connected therewith or incidental thereto. It is expected to bring together the respective efforts of the Central Government and State Governments to achieve the intended objective of setting up and ensuring smooth and successful functioning of SEZs. It provides exemption from taxes, duties and cess leviable under various statutes. The SEZ Act comprises income tax concessions for both SEZ units and SEZ developers.**

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

## FISCAL BENEFITS

The SEZ Act provides exemption from taxes, duties and cess leviable under various statutes listed in the First Schedule to the SEZ Act in respect of any goods or services exported out of or imported into, or procured from the unit in an SEZ or Developer. The following statutes are listed in the First Schedule:

- a) The Agricultural Produce Cess Act, 1940
- b) The Coffee Act, 1942
- c) The Mica Mines Labour Welfare Fund Act, 1946
- d) The Rubber Act, 1947
- e) The Tea Act, 1953
- f) The Salt Cess Act, 1953
- g) The Medicinal and Toilet Preparations (Excise Duties) Act, 1955
- h) The Additional Duties of Excise (Goods of Special Importance) Act, 1957

- i) The Sugar (Regulation of Production) Act, 1961
- j) The Textiles Committee Act, 1963
- k) The Produce Cess Act, 1966
- l) The Marine Products Export Development Authority Act, 1972
- m) The Coal Mines (Conservation and Development) Act, 1974
- n) The Oil Industry (Development) Act, 1974
- o) The Tobacco Cess Act, 1975
- p) The Additional Duties of Excise (Textile and Textile Articles) Act, 1978
- q) The Sugar Cess Act, 1982
- r) The Jute Manufactures Cess Act, 1983
- s) The Agricultural and Processed Food Products Export Cess Act, 1985
- t) The Spices Cess Act, 1986
- u) The Research and Development Cess Act, 1986.

Section 26 of SEZ Act provides various Exemptions, Drawbacks and Concessions to a Developer and an Entrepreneur which are as follows:

- a) Exemption from any duty of customs, under the Customs Act, 1962 or the Customs Tariff Act, 1975 or any other law for the time being in force, on goods imported into, or service provided in, a Special Economic Zone or a



— CA. Chythanya K.K

*(The author is a member of the Institute. He can be reached at chyti@vsnl.net)*

Unit, to carry on the authorised operations by the Developer or entrepreneur;

- b) Exemption from any duty of customs, under the Customs Act, 1962 or the Customs Tariff Act, 1975 or any other law for the time being in force, on goods exported from, or services provided, from a Special Economic Zone or from a Unit, to any place outside India;
- c) Exemption from any duty of excise, under the Central Excise Act, 1944 or the Central Excise Tariff Act, 1985 or any other law for the time being in force, on goods brought from Domestic Tariff Area to a Special Economic Zone or Unit, to carry on the authorised operations by the Developer or entrepreneur;
- d) Drawback or such other benefits as may be admissible from time to time on goods brought or services provided, from the Domestic Tariff Area into a Special Economic Zone or Unit or services provided in a Special Economic Zone or Unit by the service providers located outside India to carry on the authorised operations by the Developer or entrepreneur;
- e) Exemption from service tax under Chapter V of the Finance Act, 1994 on taxable services provided to a Developer or Unit to carry on the authorised operations in a Special Economic Zone;
- f) Exemption from the Securities Transaction Tax leviable under Section 98 of the Finance (No. 2) Act, 2004 in case the taxable securities transactions are entered into by a non-resident through the International Financial Services Centre;
- g) Exemption from the levy of taxes on the sale or purchase of goods other than newspapers under the Central Sales Tax Act, 1956 if such goods are meant to carry on the authorised operations by the Developer or entrepreneur.

For providing the above incentives, the Central Government may impose such terms and conditions as it may deem fit.

### **Exemption from Securities Transaction Tax**

The SEZ Act provides for exemption from Securities Transaction Tax to non-residents in certain cases. Section 26(1)(f) provides for an exemption from the securities transaction tax leviable under Section 98 of the Finance (No. 2) Act, 2004 in case the taxable securities transactions are entered into by a non-resident through the International Financial Services Centre. The above benefit is available only to a non-resident who enters into the taxable securities transactions through the International Financial Services Centre situated in an SEZ.

Doubts arise as to the eligibility of such non-residents for exemption under section 10(38) of the Income Tax Act in respect of long-term capital gains arising from such securities transactions. While Section 10(38) makes eligibility to the security transaction tax as a precondition for exemption, Section 26(1)(f) of SEZ Act exempts such Securities Transaction Tax.

It may be noted that Section 10(38) refers to chargeability to securities transaction tax under Chapter VII of the Finance (No.2) Act, 2004. Section 26(1)(f) of the SEZ Act exempts what is chargeable to tax under Chapter VII of the Finance (No.2) Act, 2004. In spite of Section 26(1)(f), the chargeability of the transaction under Chapter VII of the Finance (No.2) Act, 2004 remains intact. Therefore, exemption under Section 10(38) of the Income tax may be available to a non-resident even in respect of securities transactions, which are exempt from Securities Transaction Tax under Section 26(1)(f) of the SEZ Act.

### **Issues in the Area of Sales Tax Laws**

- (1) **Is sale made to an SEZ unit an export?** An SEZ shall be deemed to be a territory outside the customs territory of India for purposes of undertaking the authorised operations as per Section 53(1). However, any sale made

to an SEZ unit is not an export as per Section 5(1) of the CST Act, which provides that a sale is export of goods out of the territory of India only if the sale either occasions such export or is effected by a transfer of documents of title to the goods after the goods have crossed the customs frontiers of India. There is difference between words "outside the customs territory" as per Section 53(1) of SEZ Act and "outside the territory of India" as per Section 5(1) of the CST Act.

- (2) **Can there be a high-sea sale in the course of purchase from an SEZ unit?** An SEZ shall be deemed to be a port, airport, inland container depot, land station and land customs stations, as the case may be, under Section 7 of the Customs Act, 1962, as provided in Section 53(2). This will give rise to an interesting proposition as to whether a person can effect high-sea sales in terms of Section 5(2) of CST Act when he procures goods from an SEZ. Section 5(2) provides that a sale or purchase of goods shall be deemed to take place in the course of import of the goods into the territory of India only if the sale or purchase either occasions such import or is effected by a transfer of documents of title to the goods before the goods have crossed the customs frontiers of India. According to Section 2(ab) of the CST Act 'crossing the customs frontiers of India' means crossing the limits of the area of a customs station in which imported goods or export goods are ordinarily kept before clearance by customs authorities. Explanation to Section 2(ab) clarifies that "customs station" and "customs authorities" shall have the same meanings as in the Customs Act, 1962, (52 of 1962). Although SEZ is a customs station for the above purpose, the phrase "crossing the customs frontiers of India" should be read with reference to the import of goods "into the territory of India". Therefore, it may not be an acceptable proposition to call sale effected by a transfer of documents of title to goods before the goods have crossed the

SEZ as a sale in the course of imports.

### Incentives under Central Sales Tax Act, 1956

- a) Section 8 (6) of the CST Act exempts from CST 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;
- b) The above benefit is 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.

### Incentive under local sales tax/value added tax laws

- a) 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.
- b) Rule 5(5) of SEZ Rules provides that before recommending any proposal for setting up of an SEZ, the State Government shall endeavour that the proposed SEZ Units and Developer get various incentives which inter alia include exemption from State and local taxes, levies and duties, including stamp duty, and taxes levied by local bodies on goods required for authorised operations by a Unit or Developer, and the goods sold by a Unit in the Domestic Tariff Area except the goods procured from domestic tariff area and sold as it is.
- c) Thus, the SEZ Act and the Rule provide for involvement of the State Government with clear indication of incentives offered under

State fiscal laws.

### INCOME TAX INCENTIVES

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;
- Shall apply to developer or entrepreneur;
- For carrying on authorised operations in an SEZ or Unit;
- Subject to modifications specified in Second Schedule;

or Not Ordinarily Resident is exempt.

- b) **SECTION 10[23][g]:** Dividend/Interest/long-term capital gains of an Infrastructure Fund/Infrastructure Capital Company/Co-operative Bank from Investments made by way of shares or long-term finance in any Enterprise or Undertaking wholly engaged in the business of Development of SEZ. However, it may be noted that the entire clause (23G) has been omitted by the Finance Act, 2006 with effect from 01.04.2007. Therefore, the amendment to the said clause as provided by the Second Schedule to the SEZ Act may not survive in the absence of parent clause in the Income Tax Act.
- c) **SECTION 54GA:** This Section provides Exemption of Capital Gains on transfer of assets in cases of shifting of Industrial Undertaking from Urban area to any SEZ.

d) **SECTION 80LA:** This Section provides 100% deduction for 5 years & 50% deduction for the next 5 years in respect of income from Offshore Banking Unit (OBU) in an SEZ or from an International Financial Services Centre (IFSC). Similar deduction is available in respect of income from other businesses referred in Section 6[1] of Banking Regulations Act with an Undertaking located in SEZ or any other

Undertaking, which develops, develops and operates or develops, operates and maintains an SEZ.

- e) **SECTION 115JB(6):** This sub-section provides that provisions of Section 115JB do not apply to income accrued or arising on or after 01.04.2005 from any business carried

#### INCOME TAX BENEFITS MAY BE SUMMARISED IN THE FOLLOWING TABLE

PERSON	SECTION	INCOME
Developer & Co-developer	80 IAB, 115 O	Development Income
SEZ Authority	80 IAB, 115 O	–do–
Infrastructure Cap Fund/ Company or Co-op Society	10 (23G)	Dividend, Interest and Long-term Capital Gains
Entrepreneur	10 AA / 54 GA	Business Income
Offshore Banking Unit	80 LA, 197 A (1D)	Interest
Non-resident/Not Ordinary Resident	10 (15) (viii)	Interest on Deposit
International Financial Services Centre	80 LA	Interest
Non-resident	26(1)(f) of SEZ Act	Security Transaction
Investor in Shares	115 (O) (6), 10(34)	Dividend Income

### SECOND SCHEDULE TO THE SEZ ACT

Relief provided by the Second Schedule to the SEZ Act is summarised in the following paragraphs;

- a) **SECTION 10[15][viii]:** Interest on deposit made in an Offshore Banking Unit on or after 01.04.2005 in the hands of a Non-resident

on, or services rendered, by an entrepreneur or a Developer, in a Unit or SEZ, as the case may be.

- f) **SECTION 115(O)(6):** This Section exempts an Undertaking or Enterprise engaged in developing or developing and operating or developing, operating and maintaining an SEZ from tax on distributed profits on any amount declared, distributed or paid by such Developer or Enterprise by way of dividend on or after 01.04.2005, out of its current income, either in the hands of Developer or Enterprise or person receiving such dividends not falling under Section 10[23G]. Strangely, this section not only exempts the dividend distributor from additional tax but also exempts the dividend recipient who in the first place is not liable to such tax at all. It is not clear whether the intention of this provision is to exempt the recipient from tax on dividend received independent of Section 10(34).

It may be noted that Section 10(34) exempts any income by way of dividends referred to in Section 115-O. A combined reading of the above provisions suggests that the exemption of dividend from tax in the hands of the recipient would be available even if the dividend tax is not paid on such dividend. Further, the aforesaid exemption under Section 115-O(6) remains even if for any reason the exemption under Section 10(34) is withdrawn. However, in such a case, while such dividend is includible in the total income, no tax may be payable thereon. This is for the reason that the incomes referred to in Section 10 of Chapter III are not only exempt but also not includible in computation of total income. This will mean that if and when the benefit under Section 10(34) is withdrawn, the dividend referred to in Section 115-O(6) would be included in the total income but the exemption will have to be given effect by applying the provisions of Section 110. Section 110 provides that where there is included in the total income of an assessee any income on which no income tax is payable under the provisions of this Act, the assessee shall be entitled to a deduction, from the amount of income tax with which he is chargeable on his total income, of an amount equal to the income tax calculated at the average rate of income tax on the amount on which no income tax is payable.

- g) **An Explanation has been inserted to Section 10[34]** that provides that the Dividend referred to in Section 115-O should not be included in the Total Income of a Developer or Entrepreneur. This Explanation seems to serve no purpose as Section 10(34) being a provision falling in Section 10 would have anyway had the effect of dividend income being excluded from the total income. Further, the Explanation is restricted in its application only to the

developer or entrepreneur and not to other recipients of dividend referred to in Section 115-O(6). The Developer or Entrepreneur referred to in this Explanation are ordinarily the payers of dividend in respect of whom Section 2(34) is of no relevance.

- h) **SECTION 197A[1D]**: This Section provides that the Offshore Banking Unit shall not deduct tax from Interest paid of deposit made on or after 01.04.2005 by a Non-resident or a person Not Ordinarily Resident, or on borrowing from a Non-resident or a person Not Ordinarily Resident on or after 01.04.2005.

### Salient features of Section 10AA

- a) This Section applies to an Entrepreneur referred in Section 2[j] of SEZ Act;

§ 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:

- 100% for first 5 consecutive years;
- 50% for next 5 years;
- 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).

- b) 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;

- c) In respect of a Unit initially located in any

FTZ or EPZ is subsequently located in SEZ by way of conversion, a period of 10 Assessment Years shall be reckoned from Assessment Year relevant to previous year in which Unit began to manufacture or produce or process such articles or things or services in such FPZ or EPZ;

- d) 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;

- e) The Business loss or Capital loss relating to the business of SEZ Unit is allowed to be carried forward or set-off;

- f) Issues under Section 10AA: The following issues arise from this section:

§ The bridging between Section 10A and Section 10AA has not come out clearly. Section 10A (7B) provides non-application of Section 10A to units in SEZ beginning operations during previous year relevant to assessment year commencing on or after 1.4.2006. In other words, Section 10A would not apply to units in SEZ commencing operations on or after 1.4.2005. This means Section 10A continues to apply to units in SEZ commencing operations before 1.4.2005. However, three Provisos below Section 10AA(3) provide for a transition from Section 10A to Section 10AA;

- (i) First Proviso makes an incorrect reference to Section 10A(7B) by calling a disabling section as an enabling section. This is for the reason that Section 10A(7B) provides that the benefit of section 10A would not apply to SEZ units beginning operations on or after 01.04.2005 whereas the First Proviso to Section 10AA(3) refers to SEZ unit whose profits are not included in the total income by application of Section 10A(7B).

- (ii) First Proviso provides that benefit of Section 10AA would be available to

older units for unexpired portion. While doing so, First Proviso refers to deduction under Section 10AA(3). However, Section 10AA(3) provides for no deduction but consequences for wrongful utilisation of SEZRR account;

(iii) While 10A continues to apply for 5 + 2 + 3 years, First Proviso to Section 10AA may provide relief for unexpired portion. This could mean Section 10A and Section 10AA operating on parallel basis leading to possible double deduction in case of such unit;

(iv) Legislative intent may be ascertained by the following harmonious construction;

- New units would be covered by Section 10AA;
- Old units will be covered by Section 10A up to 31.3.2005 and by Section 10AA on or after 1.4.2005 for unexpired portion of 10 years and additional 5 years subject to creation of SEZRR;
- However, old units having already availed 10 years holiday under Section 10A do not get any benefit under Section 10AA including additional 5 years on creation of SEZRR;

§ There is a serious flaw in the formula for determination of quantum of deduction as the denominator is the total turnover of the business carried on by assessee. In fact, similar flaw existed in Section 10A when proposed in the Finance Bill but rectified at the time of passage of the Finance Bill.

§ There is one more issue and this relates to the time limit before which the consideration shall be received in, or brought into, India. Unlike Section 10A and Section 10B, in Section 10AA there is no time limit for receiving or bringing in. In the absence of time limit, while the assessee may choose to claim the benefit under Section 10AA in

respect of entire consideration irrespective of consideration received or brought in during the previous year, the assessing officer may adopt a stricter stand of allowing the benefit only in respect of consideration actually received or brought in during the previous year. There is no mechanism in Sections 154 and 155 providing for rectification in case of consideration received or brought into subsequently. Therefore, it is desirable that a suitable amendment should be made in Section 10AA and Section 155 on the same lines as Section 10A.

### Salient Features of Section 80IAB

- a) This Section applies to Developer of SEZ;
- b) This Section provides for a Deduction of 100% of Profits derived from business of Development of SEZ;
- c) The Deduction is available for 10 consecutive years;
- d) 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;
- e) If a Developer had already claimed Deduction under Section 80 IA [13], he shall get the Deduction under this Section only for the unexpired period;
- f) If a Developer transfers the operations & maintenance of SEZ to another Developer, the Transferee Developer gets the Deduction for remaining period;

### CONCLUSION

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. A proper understanding between the Commerce Ministry and the Finance Ministry would go a long way in ensuring the same. □