Indian Special Economic Zones: An Overview

A Special Economic Zone (SEZ) is a specifically delineated duty-free enclave that is deemed to be foreign territory for the purposes of trade operations, duties and tariffs. Unlike most international SEZs, which are primarily developed by the respective governments, the Indian SEZ policy provides for development of such zones in the government, private or joint sector, thereby offering equal opportunity to both Indian and international private developers. This article provides an overview of SEZs in the Indian context.

Special Economic Zones (SEZs) are duty free enclaves within a country and are treated as foreign territories for compliance of various legislations, and in particular fiscal legislations. These zones are called Special Economic Zones primarily because they are governed by special legislative policies and systems, which are not otherwise applicable in the country. Internationally, SEZs may be known by various names, viz., export processing zone, coastal economic open zone, free trade zone, economic and technological development zone, etc.

Why SEZs?

The need for development of SEZs can be attributed to various factors: viz., foreign investment, technological and know-how advancement, infrastructure development, development of backward regions, employment generation, etc.

The Indian Scenario

The Central Government in exercise of the powers conferred under Section 5 of the Foreign Trade (Development and Regulation Act), 1992, issues and notifies the Exim policy (now called Foreign Trade Policy). This is announced for a period of five years and reviewed every year with the intention of introducing any necessary changes in tariffs and trade facilitation measures, depending on the changing trends in world trade. The concept of SEZs was introduced for the first time in India through the Foreign Trade Policy of 2000-2001.

The review of the Foreign Trade Policy every year leads to a lot of uncertainties, which generally has a negative impact on investor confidence level. Also, the SEZ policy in its original form was not able to generate the expected private investment. Thus, to instil confidence in investors and signal the Government's commitment to a stable SEZ regime, the SEZs Act, 2005, was passed by the Indian Parliament in May 2005 and became effective from 10 February 2006 (except for provisions relating to SEZ authority). The SEZ Rules 2006 ('Rules') also came into effect on the same date. So far, 164 new SEZs have been approved in the private sector, of which eight have already become operational.

The SEZs Act, 2005, ('Act') aims at providing for the establishment, development and management of SEZs for the promotion of exports and for matters connected therewith or incidental thereto. This is a special Act, which extends to the whole of India and overrides anything inconsistent contained in any other legislation in force.

The Act and the Rules have been divided into eight Chapters each. In addition to these, there are three Schedules in the Act. The First Schedule to the Act lists 21 enactments. All tax duties and cesses payable under these enactments are not applicable to SEZs. The Second Schedule incorporates amendments to the Income Tax Act, 1961. The Third Schedule makes amendments to Insurance Act, 1938; Banking Regulations Act, 1949; and Stamp Act, 1899.

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Important definitions given in the Act and Rules include Authorised Operations, Approval Committee, Board of Approval, Developer, Co-developer, Entrepreneur, Export, Import, Unit, Manufacture, Services, Infrastructure Facilities, Services, Free Trade Warehousing, International Financial Services Centre, Offshore Banking Unit, Capital Goods, Consumables, SEZ for Multi-Product and SEZ For Specific Sector.

'Developer' is one who develops or establishes the SEZ. Under the Act, it is defined to mean a person or the State Government, which has been granted a letter of approval by the Central Government, and includes an authority and co-developer.

'Unit' refers to a unit set up by an entrepreneur in an SEZ, and includes an offshore banking unit and international financial services centre.

'Manufacture' means to make, produce, fabricate, assemble, process or bring into existence, by hand or by machine, a new product having a distinctive name, character or use. It includes processes such as refrigeration, cutting, polishing, blending, repair, remaking and re-engineering, and encompasses agriculture, aquaculture, animal husbandry, floriculture, horticulture, pisciculture, poultry, sericulture, viticulture and mining;

The definition of 'Manufacture' as existing in the foreign trade policy includes activities relating to repacking, labelling, refurbishing, testing and calibration. However, in the Act, Manufacture is defined by excluding these activities.

'Service' means tradable services earning foreign exchange and is covered under General Agreement on Trade in Services or such other services as may be prescribed by the Central Government.

'Capital Goods' means any plant, machinery, equipment or accessories required for manufacture or production, either directly or indirectly, of goods or for rendering services, or for development of Special Economic Zone, including those required for construction, replacement, modernisation, technological upgradation or expansion, and also includes material handling equipment, packaging machinery and equipment, refractories for initial lining, refrigeration equipment, power generating sets, machine tools, equipment and instruments for testing, research and development, quality and pollution control systems, for use in manufacturing, construction, mining, agriculture, aquaculture, animal husbandry, floriculture, horticulture, pisciculture, poultry, sericulture and viticulture, and in the services sector.

An important change has been effected in the definition of 'Capital Goods'—it now includes goods required for the construction and development of SEZs.

'Consumable' is any item required for a manufacturing process, which may or may not be substantially or totally consumed during a manufacturing process but does not necessarily form part of the end product. There is an important change in the definition—it now includes fuel, high speed diesel oil, light diesel oil and other such petroleum products.

Board of Approval is the designated authority for approval of SEZs and other related issues. Board of Approval is headed by the Additional Secretary of the Union Ministry of Commerce and Industry. It consists of 18 members, excluding the chairperson. The Board, *inter alia*, approves or rejects proposals for setting up an SEZ, grants approval for authorised operations in the SEZ, grants approval to the Developer and Unit for foreign collaboration and FDI, and okays industrial licenses, suspension of letter of approval, etc.

Approval Committee is the designated authority for setting up a Unit in the SEZ. It is headed by the concerned Development Commissioner, and consists of eight members excluding the chairperson. This Committee, amongst other things, approves or rejects proposals for setting up Units in SEZs.

It has to be clearly understood that there are two separate authorities governing both Developer and Unit.

How to Set Up an SEZ

Under the Act, SEZs can be set up for manufacturing goods and rendering services and for trading and warehousing activities. Sections 3 to 7 of the Act read with Rules 3 to 16 provide for establishment of the SEZ by the Central Government, State Government or by any other person for manufacturing goods and for provision of services, or for both, or for trading and warehousing. In the erstwhile SEZ policy, there was no provision for setting up of SEZs by the Central Government.

The application for setting up an SEZ has to be made in Form A by the Developer to the State Government. The application can also be sent directly to the Board of Approval (Section 3 of the Act and Rule 3). Where the application has been sent to the State Government, the Government has to forward the application received to the Board of Approval within 45 days of receipt (Rule 4). While forwarding the application, the State Government should ensure that the following requirement for minimum area of land is fulfilled by the Applicant (Rule 4 (2)).

It is pertinent to note that land has to be contiguous for setting up of multi-product SEZs and sector-specific SEZs, but this is not the case when setting up an SEZ for free trade and warehousing (FTWZ).

A. Requirement of Minimum Area of Land (Rule 5 (2)):

Type	Minimum Area	*Special Cases
Multi-product	Contiguous area of1000 Hectares	Contiguous area of200 Hectares
Multi-services	Contiguous area of100 Hectares	Contiguous area of100 Hectares
Sector-specific; SEZ in Airport/Port	Contiguous area of100 Hectares	Contiguous area of50 Hectares
IT, **Gems and Jewellery, **Bio tech, **non-conventional energy	Contiguous area of 10 Hectares and built-up area of 1 lakh square metres for IT	Contiguous area of 10 Hectares and minimum built-up area of 1 lakh square metres for IT
Free trade and warehousing (FTWZ)	40 Hectares and minimum built up area of 1 lakh square metres	Contiguous area of 40 Hectares and minimum built-up area of 1 lakh square metres

**Special Cases: States of Assam, Meghalaya, Nagaland, Mizoram, Manipur, Tripura, Himachal Pradesh, Uttaranchal, Sikkim, J&K, and Goa and UTs. ** Recently empowered group of ministers has resolved that minimum built-up area in case of biotech and non-conventional energy should be 40,000 square metres, and 50,000 square metres in case of gems and jewellery.*

B. Requirement of Minimum Equity Participation (Rule 5 (4)):

In case the Developer or the Co-developer proposes to undertake business, residential or recreational facilities in a SEZ through a separate entity or a special purpose vehicle being a company formed and registered under the Companies Act, 1956 (1 of 1956), then such Developer or Co-developer should invariably hold a minimum of 26% equity in the said separate entity or special purpose vehicle. Thus, logically if the separate entity or a special purpose vehicle is an unincorporated entity, the requirement as to minimum percentage holding by the Developer or the Co-developer would not apply.

C. Obligations on the Part of the State Government (Rule 5 (5)):

The State Government, before forwarding the application to the Board, should endeavour that

the provisions of Rule 5(5) are complied with. Among other things, it is provided that the State Government should declare the SEZ as public utility service. This declaration as public utility means that the employees of the SEZ would, among other things, be required to give notice to their employer six weeks in advance of proceeding on strike so that conciliatory proceedings can be started. During the conciliatory proceedings and seven days after their completion, the employees cannot go on strike.

The State Government should also specify whether the proposed area has been declared as a reserved area or an ecologically fragile region by the concerned authority (Rule 5 (6)). If the Board is satisfied with the proposal or if the alterations or modifications as suggested by the Board have been carried out by the Developer, the Board of Approval would communicate the same to the Central Government (Rule 3(9)).

The Central Government shall, within 30 days of receipt of communication from the Board of Approval, issue a letter of approval in Form B to the person or to the State Government. (Section 3(10) and Rule 6(1)). The Central Government may issue the letter of approval specifying the terms, conditions, obligations and entitlements. Under proviso to Section 3(10), the Central Government is entitled to approve more than one Developer in an SEZ in instances where one Developer does not have in possession the required minimum contiguous area of land.

Similarly, any person or the State Government intending to provide infrastructural facilities or undertaking any authorised operations in the SEZ should submit an application to Board of Approval. The Central Government shall, within 30 days of the receipt of communication from the Board of Approval, issue Letter of Approval in Form-C to the person or to the State Government for providing infrastructural facilities. The person to whom letter of approval is issued in Form–C shall be called as Co Developer (Section 3(11).

A Letter of Approval shall be valid for three years from the date of grant, within which effective steps shall be taken by the Developer to implement the approved proposal (Rule 6(2). The emphasis is only on taking effective steps and not completing the process of setting up the SEZ within the period of three years. However, what these 'effective steps' are has not been defined in either the Act or the Rules. This period of three years can be extended by a maximum period of two years, if the Board is satisfied about the reasons for the same, upon a request made in writing by the Developer or Co-developer.

After the grant of the Letter of Approval, the Developer shall submit the exact particulars of the area identified, together with proof of legal right and possession and a certificate from the State Government or authorised agency stating that the said area is free from all encumbrances and that the Developer shall also comply with other terms and conditions specified in the Letter of Approval. If the Developer holds leasehold rights over the area, the same should be for a period of not less than 20 years. The area identified shall be contiguous (wherever required) and should not have a public thoroughfare (Section 4 read with Rule 7).

After being satisfied about the details and compliance of the terms and conditions of the Letter of Approval, the Central Government shall notify the identified area as a SEZ (Section 4 read with Rule 8). After this, the Developer shall submit to the Board the details of operations proposed to be undertaken in the SEZ for obtaining authorisation to start operations in the notified SEZ (Section 4 read with Rule 9).

The area within the SEZ can be classified as processing area and non processing area. The area for setting up of a Unit for manufacturing goods, rendering services and trading or warehousing is termed as processing area, and any other area is termed non-processing area. Thus, virtually the Developer can construct housing, recreational and other facilities in the non-processing area and get commercial benefit. It is pertinent to note that the Developer can earmark a maximum of 50% of the total area of the SEZ as non-processing area for sector-specific SEZs, and 75%

in case of other SEZs (Recently, the Empowered Group of Ministers stipulated that the processing area in SEZs shall be 35%). The demarcation of the area into processing, trading, warehousing and non-processing zone shall be done by the Development Commissioner (Section 6 read with Rule 11). The areas designated as processing area, free trade and warehousing area should be securely fenced.

Pursuant to Rule 11, a Developer is barred from selling any land in the SEZ. The Developer is allowed only to lease land or built-up space in the processing area or FTWZ to entrepreneurs holding a valid Letter of Approval issued under Rule 19, and the lease period shall be coterminous with the validity of the Letter of Approval. The Developer can also allot land in the non-processing area for business and social purposes, including educational institutions, hospitals, hotels, recreation and entertainment facilities, residential and business complexes.

How to Set Up a Unit in an SEZ

Provisions relating to establishment of a Unit in SEZ are contained in Sections 15 to 19 of the Act read with Rules 17 to 21. Any person desirous of setting a Unit in SEZ has to prefer a consolidated application to the designated Development Commissioner in Form F, in five copies, with a copy to the Developer (Section 15 read with Rule 17). However, in cases where the Unit is engaged in a business in which FDI is not permissible under automatic route, or in a business in respect of which an industrial licence is required, under the provisions of Industries (Development & Regulations) Act, 1951, then the application will have to be preferred to the Board of Approval and not to the Development Commissioner.

Applications for registration under Income Tax and Central Labour Laws will have to be preferred separately by the person to the respective departments.

The development commissioner shall get the application scrutinised and placed before the Approval Committee or the Board of Approval as the case may be. The Approval Committee may approve, modify or reject the proposal within 15 days of receipt, and similarly the Board of Approval may approve, modify or reject the proposal within 45 days of receipt (Rule 18). It is pertinent to note that no proposal for SEZ would be considered if it is for any of the purposes listed under Rule 18(4).

If the proposal is approved, the Development Commissioner issues a Letter of Approval in Form G. This Letter of Approval shall be valid for a period of one year from the date of grant within which Unit shall commence commercial production or service or FTWZ activity as the case may be. This can be extended by another period of two years, and further extended by one year subject to the condition that two-thirds of activities, including construction, have been completed and a certificate to that extent is produced from a chartered engineer (Rule 19).

If the Unit has not commenced production or service activity within the validity period or the extended validity period, the Letter of Approval shall be deemed to have lapsed with effect from the date on which its validity expired (Rule 19).

The Letter of Approval so granted shall be valid for five years from the date of commencement of production or service activity. After expiry of the period, the Development Commissioner can renew it for another period of five years at a time (Rule 19).

International Financial Services Centre (IFSC)

Simply put, an IFSC is a centre in which corporate treasury and financial services benefit from preferential tax treatment. The Central Government shall prescribe the requirements for setting up an IFSC. However, till date no guidelines have been prescribed.

Offshore Banking Unit (OBU)

An OBU is a deemed foreign branch of the parent bank, which is situated within India and undertakes international banking business, involving foreign currency denominated assets

and liabilities. Under the Act, it is defined to mean a branch of the bank located in the SEZ with authorisation to undertake specified operations. Banks operating in India are eligible to set up OBUs. An application for setting up an OBU has to be preferred to the RBI. An OBU can deal only in foreign currency and not in Indian Rupees, except for having a special rupee account out of the convertible fund to meet day-to-day expenditures. Unlike Units in SEZs, OBUs are not under the control of the Development Commissioner—rather, they function under the supervision and regulation of the RBI.

Other Procedural Issues Under the Act

Any person aggrieved by the decision of the Approval Committee can prefer appeal to the Board of Approval in Form J, together with a fee of Rs 2,500, within 30 days. The appellant can appear by himself, or through authorised employees, or be represented by a legal practitioner or a practising CA/CS/CWA.

Developer and Unit shall preserve books of accounts for a period of seven years from the end of the relevant financial year. In case the Unit is engaged in both manufacturing and trading activities, accounts will have to be separately maintained in respect of both manufacturing and trading. The Developer shall file with the Development Commissioner in Form E a quarterly performance report (QPR), and similarly a Unit shall file annual performance report (APR).

Search or seizure in the SEZ or in the Unit should be carried out only after prior intimation to the Development Commissioner. The Development Commissioner would issue an identity card to every person employed or residing in the SEZ.

SEZs and Various Legislations

The Government has showered several concessions and benefits on the SEZ under several legislations. Some of them are discussed hereunder:

a. Income Tax: The Developer is exempt from payment of MAT on any income arising from business carried on or services rendered. SEZ would also enjoy 100% tax holiday for a period of 10 consecutive years out of 15, beginning from the year in which the SEZ was notified. The Developer is also exempt from capital gains and interest and payment of dividend distribution tax.

Profits and gains derived from export of goods and services derived by the Unit are exempt from payment of MAT. Similarly, the Unit would enjoy a tax holiday for 15 years (100% for first five years, 50% for the next five, and 50% for the remaining five years, subject to the creation of SEZ reinvestment allowance reserve. Income of OBU and IFSC is 100% exempt for the first five years and 50% for the next five. Units are exempt from capital gains arising from transfer of assets to an SEZ. However, there is no exemption from payment of dividend distribution tax by a Unit.

b. Central Sales Tax: SEZ Developers and Units are exempt from payment of Central Sales Tax. All the supplies from the DTA to the Developer or the Unit are exempt from payment of Central Sales Tax on inter-state sale of goods and purchase. To avail of this benefit, the dealer availing exemption should submit a declaration in Form I.

c. Central Excise, Customs and Service Tax: Any goods imported into or procured from the DTA by the Developer or the Unit shall be exempt from excise duty and customs duty. Goods required for setting up SEZ shall be exempt from payment of any duty. It is pertinent to note that all the supplies from DTA to SEZ are treated as export and thus the DTA supplier can claim all the benefits like advance licence, DEPB and duty drawback, etc. However, any sale by the Unit to the DTA would attract applicable duties.

SEZ is deemed as a port, airport, inland container depot and land customs station. Under normal circumstances, the cargo imported into the country can be unloaded only at notified ports/airports/land custom stations, and similarly cargo for export can be loaded only at notified ports/airports/land custom stations.

With this deeming provision, SEZ shall be treated as Customs Station for all practical purposes.

The Developer may export or transfer capital goods and spares including construction equipment that have become obsolete or surplus to another Developer, or Unit. The Developer is allowed to move goods imported or procured from DTA for the purposes of authorised operations in processing area as well as the non-processing area of SEZ.

If services are imported from the DTA by the Developer or the Unit, the same would be exempt from payment of service tax, provided the same are for the purpose of authorised operations in the SEZ. It is immaterial as to whether the same have been consumed within the SEZ or not.

d. Environmental Laws: Under the existing laws, environmental impact assessment (EIA) is mandatory for certain projects. EIA ascertains the likely impact on the environment of the proposed project. Similarly, under the coastal regulation zone (CRZ), development along the coastal stretch is also strictly regulated. SEZs are exempt from mandatory EIA and thus projects involving setting up of port, airport, and power plant in the SEZ will be exempt from requirement of public hearing as mandated under the EIA. Non-polluting industries in the field of IT and other service industries are permissible in the CRZ area of SEZ. The recreational facilities, golf courses, desalination plants, hotels and non-polluting services industries would be permissible in designated CRZ-III area.

e. Companies Act, 1956: In terms of DCA notification no. G.S.R. 565(E) dated 4 August 2003, a Unit in an SEZ can pay enhanced managerial remuneration not exceeding Rs 2,40,00,000/- per annum or Rs 20,00,000 per month in terms of Para 1 of Section II of Part II to Schedule XIII of the Companies Act, 1956. Similarly, in terms of DCA notification no. G.S.R. 670(E) dated 30 September 2002, an incumbent is exempted from complying with the requirement of staying in India for a continuous period of 12 months prior to appointment as managing director/ whole-time director/manager of the Unit in an SEZ. From the reading of both the notifications, it appears that these are applicable only with respect to companies (Units) in SEZs. What about Developers?

f. Foreign Exchange: FDI of 100% is permitted in all sectors except trading, arms and ammunition, atomic energy, distillation of alcohol, and cigarettes and manufactured tobacco substitutes. There is no time limit for realisation of export proceeds for Units. Subject to certain conditions, Units can, without prior approval of the RBI, enter into a contract in a commodity exchange or market outside India to hedge the price risk in the commodity on export/import. Units are permitted to undertake job work abroad and export goods from that country itself. (More information on Indian SEZs is available at the web site of the Union Ministry of Commerce and Industry (www.sezindia.nic.in) ❐

SEZs IN INDIA

At present there eight functional Special Economic Zones in India, located at Santa Cruz (Maharashtra), Cochin (Kerala), Kandla and Surat (Gujarat), Chennai (Tamil Nadu), Visakhapatnam (Andhra Pradesh), Falta (West Bengal) and Noida (Uttar Pradesh) in India. Further, a Special Economic Zone at Indore (Madhya Pradesh) is ready for operation. In addition, 18 approvals have been given for setting up SEZs at Positra (Gujarat), Navi Mumbai and Kopata (Maharashtra), Nanguneri (Tamil Nadu), Kulpi and Salt Lake (West Bengal), Paradeep and Gopalpur (Orissa), Bhadohi, Kanpur, Moradabad and Greater Noida (UP), Visakhapatnam and Kakinada (Andhra Pradesh), Vallarpadam/Puthuvype (Kerala) Hassan (Karnataka), Jaipur and Jodhpur (Rajasthan) on the basis of proposals received from the respective State Governments.