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Incentives and Concessions to Special Economic Zones –
An Overview

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CHAPTER – IV

Incentives and Concessions to Special Economic Zones – An Overview

4.1 Introduction

India had developed the Export Processing Zones (EPZs) to boost exports long ago. During 2000, these EPZs were transformed into SEZs when the Government formulated SEZ policies. The EPZs also enjoyed several incentives and concessions from their inception, which were increased in later years. Labour laws existed only on papers for the EPZs. Though they were enjoying fabulous incentives, their share of exports was comparatively less to the total exports of India. The exports increased considerably when the importance of SEZs became known through the success story of China and after the implementation of the SEZ policy.

4.2 An Overview of SEZ Act, 2005

An important feature of the SEZ Act is that it provides a comprehensive SEZ policy framework to satisfy the requirements of all principle stakeholders in an SEZ – the developer and operator, occupant enterprise, out zone supplier, and residents. Earlier, the policy relating to EPZs/SEZs was contained in the Foreign Trade Policy, while incentives and other facilities offered to the SEZ developer and units were implemented through various notifications and circulars issued by the concerned ministries/departments. This system did not give confidence to the investors to commit substantial funds for the development of infrastructure and in setting up units. Therefore, another major feature was added in the Act to provide expeditious and single window clearance mechanism. The responsibility for promoting and ensuring orderly development of SEZs is assigned to the Board of Approval. It is constituted by the central government. While the central government may *suo motu* set up a zone, proposals of the state governments and private developers are to be screened and approved by the Board. At the zone level, approval committees are constituted to approve/reject/modify proposals for setting up SEZ units. In addition, the Development Commissioner (DC) and his/her office is responsible for exercising administrative control over a zone. The labour commissioner’s powers are also delegated to the DC. Finally, Clause 23 requires that designated courts will be set up
by the state governments to try all suits of a civil nature and notified offences committed in the SEZs (Saeed Khan, 2008).

4.2.1 Approval Mechanism

The developer, which may be the Central or state government, a private developer or a joint venture in which both parties are involved, is entitled to set up an SEZ after identifying the proposed area. The procedure for setting up a zone may vary according to the nature of the developer. A private developer can submit his proposal for establishment of an SEZ to the state government concerned (Sec. 3, Para 2, SEZ Act). Notwithstanding, the private developer can also approach the BoA directly (Sec. 3, Para 3, SEZ Act), and thereafter, get the concurrence of the state government concerned. The state government has to get its proposal screened directly by the BoA according to Sec. 3 paragraph 4 of the SEZ Act. After consulting the respective state government, however, the Central Government can set up and notify the SEZ *suo motu* (Sec. 3, Para 4, SEZ Act). The state government has to forward the private developer’s proposal to the BoA within 45 days of the date of receipt along with its recommendation (Sec. 4, Para 1, SEZ Rules). The BoA then has the power of approving or rejecting the proposal or modifying such proposal for the establishment of SEZs. In the event of approval, the BoA communicates the same to the Central Government, which, in turn, grants formal approval to the developer (Sec. 3, Para 10, SEZ Act) through a Letter of Approval (LoA) within 30 days of receiving the communication from the BoA. The LoA is valid for a period of three years, during which the developer must take all necessary steps to ensure implementation of the approved proposal. The powers also include the decision-taking regarding authorized operations to be carried out in the SEZ by the developer as well as granting approval to the developers or units in the SEZ for foreign collaboration, foreign direct investment, and regarding infrastructure facilities (Sec. 9, Para 2, SEZ Act) (Jona Aravind Dohrmann, 2008). The proposal paths are visualized in Figures 4.1 and 4.2:
Regarding the overall establishment of an SEZ, one has to differentiate between the various processes. The aforementioned process describes the steps involved in an SEZ approval. After introducing the official agencies, which is necessary to understand the procedures in the SEZ framework, the other procedures required to get the SEZ notified in order to acquire a grant of approval for authorized operations and for setting up a unit in the SEZ.
4.2.2 Administrative structure of an SEZ

To devolve its powers to the SEZs, the BoA may delegate the aforementioned powers to one or more Development Commissioners at the Zone level (Sec. 9, Para 4 and Sec. 12 SEZ Act). The Development Commissioner is the “governor” of the particular zone or zones assigned to him, as it were. Under Sec. 12, Para 3, SEZ Act, he is required to be in charge of the SEZ and to exercise administrative control and supervision over the officers and his assistant employees. He is directly responsible to the Central Government. The Development Commissioner is also something like a link person between the Central and state governments. Inter alia, he is required to guide the entrepreneurs in setting up units in the SEZ and to ensure and take suitable steps for the promotion of exports from the SEZ. Furthermore, he has to monitor the performance of the developer and the units in the SEZ (Sec. 12, SEZ Act). At the Zone level, presumably below the Development Commissioner, there is the Approval Committee, of which the Development Commissioner is an ex-officio member. This committee has to approve, reject or modify proposals for setting up SEZ units, i.e., to approve the import or procurement of goods from the domestic tariff area or outside India as well as approve the provision of services by companies from outside India or the DTA. The utilization of goods or services or warehousing or trading in the SEZ has to be monitored by the Approval Committee. Upon former approval by the Development Commissioner, it can also allow foreign collaborations and FDI for setting up a unit, including investments by people outside India. The developer or entrepreneur is responsible to the Approval Committee for complying with the conditions set forth in the Letter of Approval or permission (Sec. 14, SEZ Act). At the Zone level, the Development Commissioner enjoys the same status as the state government and the BoA do on the national level. This means that any person intending to set up a unit for carrying out authorized operations in the SEZ has to submit a proposal to the Development Commissioner, who then forwards the same to the Approval Committee. The Committee then decides on the application (Sec. 15, SEZ Act). It also has the power to cancel the Letter of Approval if the proposal contravenes the terms and conditions in it. Applications for offshore banking have to be made directly to the Reserve Bank of India, which can specify the terms and conditions subject to which an offshore banking unit may be set up and operated in the SEZ independently (Jona Aravind Dohrmann, 2008).
4.3 An Overview of SEZ Policy 2006

The SEZ policy was implemented from 1.11.2000 to 09.02.2006 under the provisions of the Foreign Trade Policy and offers fiscal incentives through the provisions of relevant Special Economic Zones (SEZ) Acts and Rules. The Indian Special Economic Zones’ policy intends to make SEZs a powerhouse for economic growth. These SEZs are supported by world-class infrastructure coupled with attractive fiscal incentives and tax rebates, both at the Central and the State level. Further, the Indian Special Economic Zones policy attracts minimum possible regulations.

The main objectives of the SEZ policy of India are as follows:

- Generation of additional economic activity
- Promotion of export of goods and services
- Promotion of investment from domestic and foreign sources
- Creation of employment
- Development of infrastructure facilities
- Simplified procedures for development, operation, and maintenance of the Special Economic Zones and for setting up units and conducting business
- Single window clearance for setting up of a SEZ and an unit in the SEZ
- Single window clearance on matters relating to Central as well as State Governments
- Easy and simplified compliance procedures and documentations with stress on self-certification

The SEZ Rules provide different minimum land requirements for different types of Special Economic Zones. To create an investor-friendly environment, the Government of India has formulated a stable SEZ policy regime with a view to impart stability to these SEZ units. A number of meetings across the country led to the formulation of the 'The Special Economic Zones Act, 2005', which was subsequently passed by Parliament in May 2005. The SEZ Act, 2005 and SEZ Rules became effective from 10th February 2006. The SEZ Act, 2005 envisages a key role for the state governments in export promotion and creation of infrastructure. A single window SEZ approval mechanism has been provided through a 19-member inter-ministerial SEZ Board of Approval. This board considers the applications duly
recommended by the respective State Government/Union Territory administration, periodically. All decisions of the Board of Approvals are with consensus. The SEZ Rules provide for different minimum land requirement for different classes of SEZs. Every SEZ is divided into a processing area where the SEZ units can come up and the non-processing area where the supporting infrastructure is to be created.

4.4 Tax Incentives and Concession

Section 26 of the SEZ Act provides various exemptions, drawbacks, and concessions to a developer and an entrepreneur, which are as follows:

- 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 Unit, to carry on the authorized operations by the Developer or entrepreneur;
- 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;
- 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 authorized operations by the Developer or entrepreneur;
- 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 authorized operations by the Developer or entrepreneur;
- 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 authorized operations in a Special Economic Zone;
- 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;
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 authorized 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.

4.5 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.

4.6 Sales Tax Laws for SEZ

An SEZ shall be deemed to a territory outside the customs territory of India for purposes of undertaking the authorized 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 a difference between the phrases “outside the customs territory” as per Section 53(1) of the SEZ Act and “outside the territory of India” as per Section 5(1) of the CST Act. 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 gives 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 a 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 a sale affected by a transfer of documents of title to goods before the goods have crossed the SEZ as a sale in the course of imports.

4.6.1 Incentives under Central Sales Tax Act, 1956

Section 8 (6) of the CST Act exempts 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 an unit located in any Special Economic Zone or for development, operation and maintenance of SEZ by developer from CST.
This benefit is available if such registered dealer has been authorized to establish such units or to develop and maintain such Special Economic Zones by the authority specified by the Central Government in this behalf.

4.6.2 Incentive under local Sales Tax/Value Added Tax laws

Exemption from payment of Central Sales Tax or Value Added Tax on sales made from Domestic Tariff Area to SEZ units under section 26 (1) (g) of SEZ Act, 2005 are presented below:

- 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.

- 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 authorized 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.

- Thus, the SEZ Act and the Rules provide for involvement of the State Government with clear indication of incentives offered under state fiscal laws.

4.7 Exemption from Service Tax

Services rendered to the SEZ developers or SEZ units are proposed to be exempted from payment of service tax under Section 26 (1) (e) of the SEZ Act, 2005. CBEC has issued Notification No.17/2011-ST, dated 1-3-2011, to operationalize this exemption. The service provided in the SEZ and wholly consumed within the SEZ is allowed upfront exemption. Services provided outside the SEZ or is partially consumed within the SEZ, can claim exemption by way of refund.
4.8 Income Tax Incentives

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 of the 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 authorized operations in an SEZ or Unit;
- Subject to modifications specified in Second Schedule.

The income tax benefits may be summarized in the following table:

Table – 4.1: Income Tax Benefits

<table>
<thead>
<tr>
<th>Person</th>
<th>Section</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developer &amp; Co-Developer</td>
<td>80 IAB, 115 O</td>
<td>Development Income</td>
</tr>
<tr>
<td>SEZ Authority</td>
<td>80 IAB, 115 O</td>
<td>Development Income</td>
</tr>
<tr>
<td>Infrastructure Cap Fund/</td>
<td>10 (23G)</td>
<td>Dividend, Interest and Long-term Capital Gains</td>
</tr>
<tr>
<td>Company or Co-op Society</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entrepreneur</td>
<td>10 AA/ 54GA</td>
<td>Business Income</td>
</tr>
<tr>
<td>Offshore Banking Unit</td>
<td>80 LA, 197 A(1D)</td>
<td>Interest</td>
</tr>
<tr>
<td>Non-resident Indian</td>
<td>10 (15) (iii)</td>
<td>Interest on Deposit</td>
</tr>
<tr>
<td>International Financial</td>
<td>80 LA</td>
<td>Interest</td>
</tr>
<tr>
<td>Services Centre</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-resident</td>
<td>26(1)(f) of SEZ Act</td>
<td>Security Transaction</td>
</tr>
<tr>
<td>Investor in Shares</td>
<td>115 (O) (6), 10(34)</td>
<td>Dividend Income</td>
</tr>
</tbody>
</table>

Source: CA. Chaitanya K.K, Incentives to Special Economic Zones

4.8.1 Second Schedule to the SEZ Act

Relief provided by the Second Schedule to the SEZ Act is summarized in the following paragraphs:
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 or Not Ordinarily Resident is exempt.

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.

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.

Section 80LA: This section provides 100% deduction for 5 years and 50% deduction for the next five years in respect of income from Offshore Banking unit (OBU) in an SEZ or from an international financial services centre. Similar deduction is available in respect of income from other business referred in Section 3(1) of Banking Regulations Act with an Undertaking located in SEZ or any other undertaking, which develops, operates, and maintains an SEZ.

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

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. 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 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 because 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.

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 under Section 10 would have 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 the dividend referred to in Section 115-O (6). The Developer or Entrepreneur referred to in this Explanation is ordinarily the payers of dividend in respect of whom Section 2(34) is of no relevance.

4.8.2 Salient features of Section 10AA

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 the 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 utilization of sums lying in SEZ RR Account are provided on the same lines as Section 10A (1B) and (1C).
  a. 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;
  b. 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,
  c. 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;
  d. The Business loss or Capital loss relating to the business of SEZ Unit is allowed to be carried forward or set-off;
  e. Issues under Section 10AA: The following issues arise from this section:

- The bridging between Section 10A and Section 10AA lacks clarity. 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 under Section 10AA (3) provide for a transition from Section 10A to Section 10AA;

a. The First Proviso makes an incorrect reference to Section 10A(7B) by calling a disabling section as an enabling section. This is because 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).

b. The First Proviso provides that the benefit of Section 10AA would be available to older units for unexpired portion. While doing so, the First Proviso refers to deduction under Section 10AA (3). However, Section 10AA (3) provides for no deduction, but consequences for wrongful utilization of SEZRR account.

c. While Section 10A continues to apply for 5 + 2+ 3 years, the 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.

d. 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, a similar flaw existed in Section 10A when proposed in the Finance Bill, which was 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 assessees may choose to claim the benefit under Section 10AA in respect of the 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 suitable amendments be made in Section 10AA and Section 155 on the same lines as Section 10A.

4.8.3 Salient Features of Section 80IAB

- This section applies to a Developer of SEZ;
- It provides for a Deduction of 100% on Profits derived from business of Development of SEZ;
- The Deduction is available for 10 consecutive years;
- 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;
- 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;
- If a Developer transfers the operations & maintenance of SEZ to another Developer, the Transferee Developer gets the Deduction for remaining period.

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 in step 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.

4.9 Direct Tax Proposal for SEZ

The DTC proposal has ruled out any profit-linked tax benefit to Special Economic Zones (SEZs) under the proposed Direct Taxes Code (DTC), aiming at reforming tax structure in the country. However, SEZ developers and units may still get investment-linked tax deductions. The revised discussion paper on DTC released recently said profit-linked deductions are distortionary in nature as they create an
incentive to inflate profit as well as to transfer profits from a taxable entity to a non-taxable one. Therefore, it has been decided not to extend the scope or period of profit-linked deductions, since such exemptions also lead to tax evasion and avoidance. The existing SEZs will continue to get residual tax benefits committed under the SEZ Act, which came into effect in 2006. Under the SEZ Act, units get total income tax exemption on export profits for the first five years, and 50% exemption for the next five years. The developers get 100% income tax exemption for a block of consecutive 10 years of the first 15 years.

Few investors withdrew their proposal for an IT/ITES Special Economic Zone (SEZ) citing uncertainty in tax treatment towards SEZs in the Direct Taxes Code (DTC). The draft DTC does not have any clarity regarding income tax exemption to SEZ units, and if the exemption is not continued for SEZ units, it would virtually amount to "killing the SEZ scheme". Many investors are now holding back their investments in SEZs due to the uncertainty created by the DTC.

Factories, Business Processing Units, and Software Development Firms inside Special Economic Zones (SEZ) will lose all income tax benefits, the most crucial incentive for the tax-free industrial enclaves, if the direct taxes code replaces the Income Tax Act of 1961 without any change. The proposed norms also talk of tightening tax incentives to developers of SEZs, which will be notified after the new income tax law is operationalized.

The underlying principle behind not allowing income tax incentives to the SEZs is that new code discourages profit-based exemptions of any kind. The code does not mention anything about units inside SEZs, but has a separate chapter on proposed guidelines that specify how developers of the tax-free industrial enclaves will be treated in the new tax regime. If the provisions of the code are translated in to the new Income Tax Act, it is clear that SEZ units set up after the new law is implemented will not enjoy any direct tax exemptions.

The developers can enjoy the incentive until they recover all their investments and expenditure made in the developing the SEZ. This would promote greater investments in the SEZ as the developers would be allowed to set off the entire capital expenditure, without any cap on the period. Developers are not sure whether
investments that they have already made in the zones under construction will attract units though the Direct Taxes bill approved by the Cabinet retains the tax exemptions available to them under the SEZ Act. Developers and the units located in the SEZs are particularly opposed to the provision in the code that links tax exemptions to investments made rather than profits earned. The instability in the policy regime is the main reason India has not been able to attract many foreign investors. The bill approved by the Cabinet may not be the last word on tax laws for SEZs as it may be opposed by various interest groups once it is presented to the Standing Committee of Parliament for discussions.

IT companies may face another problem. Henceforth, tax saving concessions will be given only on investments, which is not good news for the IT industry, as they have no investments. Majority of the SEZs are in IT Sectors, which is why the Finance Ministry wants to stop giving tax sops to SEZs. However, this will also affect the multi-product SEZ developers and units situated there, who need tax sops.

The government is likely to clarify in the budget that special economic zone or SEZs would continue to enjoy tax benefits in their current form even after the proposed direct taxes code is implemented, providing clarity over taxation of these special enclaves. The move follows the Commerce Department’s demand for clarity on taxation of SEZs, arguing that the proposed direct taxes code had created uncertainty amongst existing and potential investors over the kind of tax breaks they would get once the new code is in place.

Moreover, the tax code is not clear about the tax treatment of units located in the SEZs. The changes in the tax regime, if executed, could substantially reduce the tax benefits enjoyed by SEZs, especially in sectors such as manufacturing where investments are low.

4.10 Sub-Contracting

SEZ Rules 2006, explains that the sub-contracting of a part of production in the SEZ Unit shall mean sub-contracting all the production processes for conversion of raw material into finished products, but only for a part of the quantity of the finished products exported during the year or in the first year of production, if the
value of goods sub-contracted shall not exceed the value of goods produced by the unit in its own premises during the first year of production. It provides the economic linkage between the exporting unit and the DTA units with resultant benefits to both. SEZ units may sub-contract part of production or production process through units in the Domestic Tariff Area or through other EOU/SEZ units. SEZ units may also sub-contract part of their production process abroad and may undertake job-work from DTA unit for export. SEZs are facilitated with out-sourcing of sub-contract capacities for export production against orders secured by other SME units. They are facilitated with out-sourcing of subcontract of production or part of production process to Indian or any foreign units. SEZs are also facilitated with out-sourcing of sub-contract capacities for export production against orders secured by other units.

4.11 Other Incentives to SEZ

❖ Foreign Direct Investment

FDI up to 100% is allowed through the automatic route for all manufacturing activities in Special Economic Zones (SEZS), except for the following activities:

- Arms and ammunition, explosives and allied items of defence equipment, defence aircrafts and warships
- Atomic substances
- Narcotic and psychotropic substances and hazardous chemicals
- Distillation and brewing of alcoholic drinks
- Cigarettes/Cigars and manufactured tobacco substitutes
- Sectoral norms as notified by government shall apply to foreign investment in services
- The cases not covered by automatic route are considered and approved by the Board of Approvals

FDI in sectors/activities to the extent permitted under the automatic route does not require any prior approval either of the Government or the Reserve Bank of India. FDI in activities not covered under the automatic route requires prior approval of the Government, which are considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance. Indian companies having foreign investment approval through FIPB route do not require any further
clearance from the Reserve Bank of India for receiving inward remittance and for the issue of shares to the non-resident investors.

❖ Off-shore Banking Units (OBUs)

Setting up of Off-shore Banking Units is allowed in SEZs. These banks are virtually foreign branches of the banks, but located in India. These OBUs are exempted from Cash Reserve Ratio (CRR) and SLR (Statutory Liquidity Ratio), and can give access to SEZ units and SEZ developers finance at international rates. The major incentive available to Off-shore Banking Unit is 100% income-tax exemption for 5 consecutive years and 50% for next 5 years under Section 80LA of the Income Tax Act (Second Schedule to the SEZ Act). Application for setting up of Off-shore Banking Unit need to be made to the Reserve Bank of India in Form-VI prescribed under Section 23 of the Banking Regulation Act, 1949. The guidelines governing the operation of Off-shore Banking Units are indicated in the Notification No. FEMA 71/2002-RB dated 7.9.2002 issued by the Reserve Bank of India.

❖ Banking/External Commercial Borrowings

External commercial borrowings by units up to USD 500 million a year is allowed without any maturity restrictions. There is freedom to bring in export proceeds without any time limit. There is flexibility to keep 100% of export proceeds in EEFC account and a freedom to make overseas investment from it. Commodity hedging is permitted and an exemption from interest rate surcharge on import finance is allowed. The Units of SEZs can also write-off unrealized export bills.

❖ Requirement under Environment (Protection) Act

Information Technology SEZ does not require environment clearance. However, environmental clearance as required under the law is required and the Board of Approvals does not include environmental clearance. For development of SEZs, public hearing is not exempted and the process of Environmental Impact Assessment (EIA) as laid down in the notification of the Ministry of Environment would have to be adhered to.

❖ Concession under Companies Act

The Act has enhanced limit of Rs.2.4 crores per annum allowed for managerial remuneration for SEZ. The regional office of Registrar of Companies in SEZs looks
after matters related to SEZ Companies. Exemption from requirement of domicile in India for 12 months prior to appointment as Director is allowed for Units of SEZ.

❖ Concession under Drugs and Cosmetics Act

SEZs are allowed exemption from port restriction under Drugs & Cosmetics Rules. The units of SEZ can sub-contract for processing of Drugs and Cosmetics.

❖ Labour Laws for SEZ units

The labour laws of the land apply to all units inside the Zone. However, the respective State Government may declare units within the SEZ as public utilities and may delegate the powers of the Labour Commissioner to the Development Commissioner of the SEZ.

❖ Public Utility Status

SEZs have been declared as a public utility by the State Governments of Andhra Pradesh, Madhya Pradesh, Maharashtra, West Bengal, Karnataka, and Uttar Pradesh from the inception of the Zone. Public utility status is at present given for six months at a time as per the Industrial Disputes Act to prevent strikes without due notice. The powers of the Labour Commissioner are delegated to the Development Commissioner of the concerned SEZs. The governments of Andhra Pradesh, West Bengal, Karnataka, and Uttar Pradesh have delegated the powers of Labour Commissioner to the Development Commissioner of SEZ in respect of the units located in the zone.

❖ Exemption from Employees’ Provident Fund Act and ESI Act

As per the Ministry of Labour, in respect of SEZs, the State Government may apply for exemption to the Central Government under Section 16 (2) of the Employees’ Provident Fund and Miscellaneous Act to SEZ for 5 years. The decision is required to be taken on case-to-case basis. In respect of the Employees’ State Insurance Act, 1948, the State Government, being the appropriate Government, may take a decision as per the powers provided under the Act.

❖ Benefits to Domestic Supplies/Supplier to SEZ

Domestic Tariff Area (DTA) means the whole of India including the territorial waters and continental shelf, excluding the areas of the SEZ. Units in SEZs may sell
goods and services including rejects or wastes or scraps or remnants or by-products of manufacturing process in the DTA on payment of specified tariff. The unit may temporarily remove goods to DTA without payment of duty for display, export promotion, exhibition, return, for job work, test repair, refining and calibration, and any other goods with the prior approval of the authorized officer. The unit can transfer goods to DTA or abroad for repair or replacement or testing quality and research and development purposes under intimation to the specified officer without payment of duty. Supplies from Domestic Tariff Area (DTA) to SEZ are treated as physical exports and supplies are entitled to Duty drawback/DEPB/DFRC/Advance License, Exemption from payment of Central Excise duty, CST exemption, Exemption from State Levies, Discharge of Export Obligation, if any, on the supplier. Duty drawback/DEPB can be claimed by the DTA supplier subject to production of disclaimer from SEZ unit/ Developer.

All SEZ units (excluding gems and jewellery units) may sell goods up to 50% of FOB value of exports subject to fulfilment of positive NFE on payment of concessional duties. Within the entitlement of domestic tariff area sale, the unit may sell in DTA its products similar to the goods, which are exported or expected to be exported from the units. Sale to direct tariff agreement is subject to mandatory requirement of registration for pharmaceutical products and inclusive of bulk drugs. For software services units, the sale in the DTA in any mode, including online data communication shall be permitted up to 50% of FOB value of exports and / or 50% of foreign exchange earned through exports of such services, where the payment of such services offered to its overseas clients, is received in foreign exchange. SEZ units associated with manufacturing gems and jewellery may sell up to 10% of FOB value of exports of the preceding year and subject to fulfilment of positive NFE. Further, in case of sale of plain jewellery, the recipient of such trade shall pay concessional rate of duty as applicable. Furthermore, in case of studded jewellery, duty shall be payable as recommended and amended from time to time. Total exemption of duties / taxes on scraps or waste or remnants, in case of said scrap or wastes of remnants are destroyed as per the approval of the customs authorities of India. If the end -products is a by-product and is included in the LOP, then it may also be sold in the direct tariff area, subject to achievement of positive NFE on payment of applicable duties within the
provisions of such laws. The sales of such by-products by units are not entitled to direct tariff area sales.

4.12 Exemption from different statute

The SEZ Act provides for a blanket exemption against all taxes, duties and cesses leviable by the following Acts:

- The Agricultural Produce Cess Act, 1940
- The Coffee Act, 1942
- The Rubber Act, 1947
- The Tea Act, 1953
- The Salt Cess Act, 1953
- The Jute Manufactures Cess Act, 1983
- The Medicinal and Toilet Preparations (Excise Duties) Act, 1955
- The Additional Duties of Excise (Goods of Special Importance) Act, 1957
- The Sugar (Regulation of Production) Act, 1961
- The Textiles Committee Act, 1963
- The Produce Cess Act, 1966
- The Marine Products Export Development Authority Act, 1972
- The Coal Mines (Conservation and Development Act, 1974
- The Oil Industry (Development) Act, 1974
- The Tobacco Cess Act, 1975
- The Sugar Cess Act, 1982
- The Additional Duties of Excise (Textile and Textile Articles) Act, 1978
- The Agricultural and Processed Food Products Export Cess Act, 1985
- The Spices Cess Act, 1986
- The Research and Development Cess Act, 1986

4.13 Conclusion

SEZ incentives can be termed as direct or indirect subsidies to exporters for improving competitiveness in foreign markets. Incentives cover a very wide range of measures and arrangements, which are made by the government to induce exporters to achieve best possible export performance. These incentives provide positive inducement, and assistance for stimulating export efforts in the economy. Incentives are the way through which SEZs can build up their export surplus.