

**SPECIAL ECONOMIC ZONES
'AN INDIAN PERSPECTIVE'**



SETH ASSOCIATES
ADVOCATES AND LEGAL CONSULTANTS

Member, AEA International,
Association of European Lawyers.

New Delhi Law Office:

C-1/16, Daryaganj, New Delhi-110002, India
Tel:+91 (11) 65352272, +91 9868119137

Corporate Law Office:

B-10, Sector 40, NOIDA-201301, N.C.R,India
Tel: +91 (120) 4352846, +91 9810155766
Fax: +91 (120) 4331304

E-mail: mail@sethassociates.com
www.sethassociates.com

INTRODUCTION

Special Economic Zone (hereinafter referred as "SEZ") is a geographical region that has economic laws that are more liberal than a country's typical economic laws. An SEZ is a trade capacity development tool, with the goal to promote rapid economic growth by using tax and business incentives to attract foreign investment and technology. Today, there are approximately 3,000 SEZs operating in 120 countries, which account for over US\$ 600 billion in exports and about 50 million jobs. By offering privileged terms, SEZs attract investment and foreign exchange, spur employment and boost the development of improved technologies and infrastructure.

There are 13 functional SEZs and about 61 SEZs, which have been approved and are under the process of establishment in India.

Most developing countries in the world have recognized the importance of facilitating international trade for the sustained growth of the economy and increased contribution to the GDP of the nation. As part of its continuing commitment to liberalization, the Government of India has also, since the last decade, adopted a multi-pronged approach to promote foreign investment in India. The Government of India has pushed ahead with second-generation reforms and has made several policy changes to achieve this objective.

The SEZ policy was first introduced in India in April 2000, as a part of the Export-Import ("EXIM") policy of India. Considering the need to enhance foreign investment and promote exports from the country and realizing the need that level playing field must be made available to the domestic enterprises and manufacturers to be competitive globally, the Government of India in April 2000 announced the introduction of Special Economic Zones policy in the country deemed to be foreign territory for the purposes of trade operations, duties and tariffs. To provide an internationally competitive and hassle free environment for exports, units were allowed to be set up in SEZ for manufacture of goods and rendering of services. All the import/export operations of the SEZ units is on self-certification basis. The units in the Zone are required to be a net foreign exchange earner but they would not be subjected to any pre-determined value addition or minimum export performance requirements. Sales in the Domestic Tariff Area by SEZ units is subject to payment of full

Custom Duty and as per import policy in force. Further Offshore banking units are being allowed to be set up in the SEZs.

The policy provides for setting up of SEZ's in the public, private, joint sector or by State Governments. It is also being envisaged that some of the existing Export Processing Zones would be converted into Special Economic Zones.

Accordingly, the Government has converted Export Processing Zones located at Kandla and Surat (Gujarat), Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra), Falta (West Bengal), Madras (Tamil Nadu), Visakhapatnam (Andhra Pradesh) and Noida (Uttar Pradesh) into a Special Economic Zones. In addition, 3 new Special Economic Zones were approved for establishment at Indore (Madhya Pradesh), Manikanchan – Salt Lake (Kolkata) and Jaipur and have already commenced operations.

India is one of the first countries in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports. Asia's first EPZ was set up in Kandla in 1965. With a view to create an environment for achieving rapid growth in exports, a Special Economic Zone policy was announced in the Export and Import (EXIM) Policy 2000. Under this policy, one of the main features is that the designated duty free enclave to be treated as foreign territory only for trade operations and duties and tariffs. No licence required for import. The manufacturing, trading or service activities are allowed.

To provide a stable economic environment for the promotion of Export-import of goods in a quick, efficient and hassle-free manner, Government of India enacted the SEZ Act, which received the assent of the President of India on June 23, 2005. The SEZ Act and the SEZ Rules, 2006 ("SEZ Rules") were notified on February 10, 2006. The SEZ Act is expected to give a big thrust to exports and consequently to the foreign direct investment ("FDI") inflows into India, and is considered to be one of the finest pieces of legislation that may well represent the future of the industrial development strategy in India. The new law is aimed at encouraging public-private partnership to develop world-class infrastructure and attract private investment (domestic and foreign), boosting economic growth, exports and employment.

The Ministry of Commerce and Industry lays down the regulations that govern the setting up and administering of the SEZs. The Central Government is

involved in notifying SEZs and in overseeing their functioning, while the State Governments play a significant lead role in the development of SEZs in their respective States by stipulating the conditions to be adhered to by an SEZ and granting the necessary approvals. The policy framework for SEZs has been enacted in the SEZ Act and the supporting procedures are laid down in SEZ Rules.

The Special Economic Zone Act 2005 came into force with effect from 10th February 2006, with SEZs Rules legally vetted and approved for notification. The SEZs Rules, inter-alia, provide for drastic simplification of procedures and for single window clearance on matters relating to central as well as state governments. Investment of the order of Rs.100,000 crores over the next 3 years with an employment potential of over 5 lakh is expected from the new SEZs apart from indirect employment during the construction period of the SEZs. Heavy investments are expected in sectors like IT, Pharma, Bio-technology, Textiles, Petro-chemicals, Auto-components, etc. The SEZ Rules provides the simplification of procedures for development, operation, and maintenance of the Special Economic Zones and for setting up and conducting business in SEZs. This includes simplified compliance procedures and documentation with an emphasis on self-certification; single window clearance for setting up of an SEZ, setting up a unit in SEZs and clearance on matters relating to Central as well as State Governments; no requirement for providing bank guarantees; contract manufacturing for foreign principals with option to obtain sub-contracting permission at the initial approval stage; and Import-Export of all items through personal baggage.

With a view to augmenting infrastructure facilities for export production it has been decided to permit the setting up of Special Economic Zones (SEZs) in the public, private, joint sector or by the State Governments. The minimum size of the Special Economic Zone shall not be less than 1000 hectares. Minimum area requirement shall, however, not be applicable to product specific and port/airport based SEZ. This measure is expected to promote self-contained areas supported by world-class infrastructure oriented towards export production. Any private/public/joint sector or State Government or its agencies can set up Special Economic Zone (SEZ).

This paper explores the Indian policy framework for an SEZ, it further discusses the various incentives available to an SEZ and an SEZ Unit, and the recent legal and regulatory developments pertaining to SEZs in India.

ADMINISTRATIVE SET UP FOR SEZS:

SEZs is governed by a three tier administrative set up

- (i) The Board of Approval is the apex body in the Department,
- (ii) The Unit Approval Committee at the Zonal level dealing with approval of units in the SEZs and other related issues, and
- (iii) Each Zone is headed by a Development Commissioner, who also heads the Unit Approval Committee.

APPROVAL MECHANISM OF SEZS

Any proposal for setting up of SEZ in the Private/Joint/State Sector is routed through the concerned State government who in turn forwards the same to the Department of Commerce with its recommendations for consideration of the Board of Approval. On the other hand, any proposals for setting up of units in the SEZ are approved at the Zonal level by the Approval Committee consisting of Development Commissioner, Customs Authorities and representatives of State Government.

Approval given for setting up new SEZs in Private/Joint/State Sector

Approvals have so far been given for setting up of 117 new Special Economic Zones (including 3 Free Trade Warehousing Zones) spread over 15 States and 2 Union Territories in the Private/Joint Sector or by the State Governments and its agencies. Of the 117 SEZs approved for establishment, 7 SEZs have already become operational, 6 SEZs are now getting ready for operation and the other are at various stages of implementation.

EXPORTS

Exports from the SEZs during 2004-2005 have registered a growth of 32% in rupee terms over the previous year. Exports during 2005-2006 (April-December) were of the order of Rs. 15,582 crores as compared to Rs. 13,225 crores during the corresponding period of last year. Exports from the SEZs during the last three years are given as under:

(Rs Crores)

Year	Export
2003-04	13,854
2004-05	18,309
April-December 2005-06 (Provisional)	15,581.79

At present, 948 units are in operation in the SEZs, providing direct employment to about 1.10 lakhs persons (about 40% of them are women). Private investment by entrepreneurs for establishing units in the SEZs is about Rs. 2000 crores.

REQUIREMENTS FOR VARIOUS CATEGORIES OF SEZ

- Multi-product SEZs to have an area of 1000 hectares or more.
- Services-Sector SEZs to have an area of 100 hectares or more.
- To support sectors where India has a competitive advantage, such as gems and jewellery, information technology, bio-technology, sector-Specific SEZs in these sectors can be set up over an area of 10 hectares or more.
- For all other sectors, the area must be atleast 100 hectares.
- The area requirement for multi-product SEZs has been relaxed to 200 hectares and for Sector-Specific SEZs to 50 hectares, for certain States (Assam, Meghalaya, Nagaland, Arunachal Pradesh, Mizoram, Manipur, Tripura Himachal Pradesh, Uttaranchal, Sikkim, Jammu & Kashmir, Goa) and Union Territories, keeping in view the difficulty in finding large tracts of contiguous land in such States/Union Territories.

BENEFITS TO SEZ DEVELOPERS

- (a) 100 per cent of the profits of the Developer arising from the business of developing an SEZ, notified after April 1, 2005 under the SEZ Act, shall be deducted from taxable income. This deduction can be claimed at the option of the assessee for any 10 consecutive years out of 15 years beginning from the year in which the SEZ has been notified by the Central Government. If a

Developer who sets up an SEZ after April 1, 2005, transfers the operation and maintenance of the SEZ to another Developer, the transferee is entitled to the above deduction of profit for the remaining period.

- (b) With regard to a Developer who is entitled to claim an exemption under Section 80-IA of the ITA, the Developer can claim an exemption for the remainder unexpired exemption period under Section 80-IA, and thereafter it can claim the 10 year tax exemption available to such Developer under Section 80-IAB.
- (c) The Developers of SEZ are not required to pay Minimum Alternate Tax.
- (d) No dividend distribution tax shall be paid by a Developer engaged in developing, operating and maintaining an SEZ.

BENEFITS TO SEZ UNITS

- (A) The Units set up in an SEZ which have begun to manufacture / provide services during the financial year beginning April 1, 2005 will get the following exemptions:
- 100% exemption of profits and gains from business for the first 5 years.
 - 50% exemption on profits and gains from business for the next 5 years.
 - 50% exemption to the extent that such amounts is re-invested in the SEZ Special Reserve Account.

If the SEZ Unit has already availed of benefits for 10 years under Section 10A of the ITA, the above exemptions are not available. Further, when a Free Trade Zone ("FTZ") or an Export Processing Zone ("EPZ") is converted into an SEZ, the Units, which have already availed of the 10-year tax exemption in an FTZ or EPZ, cannot avail of the Section 10AA exemptions.

- (B) Losses falling under the heads "Profits and Gains from Business or Profession" and "Income from Capital Gains" can be carried forward / set off as long as such loss is related to the business of the SEZ Unit.
- (C) Capital Gains on transfer of assets in case of shifting of an industrial undertaking from an urban area to an SEZ shall be exempt, provided that 1 year before, or 3 years after the transfer (i) machinery / plant was purchased for the business of the industrial undertaking in the SEZ,

- (ii) building or land was acquired or building was constructed in the SEZ, (iii) the original asset was shifted and the establishment was transferred to the SEZ and (iv) the assessee incurred such other expenses as are notified by the Central Government
- (D) Interest income received by a non-resident or a person who is not ordinarily resident in India, on a deposit made in an OBU situated in an SEZ, shall be exempt from total income
- (E) No tax deduction shall be made by the OBU from interest paid:
- (i) On deposits made on or after April 1, 2005 by a non-resident or a person not ordinarily resident in India; or
- (ii) On borrowings on or after April 1, 2005 from a non-resident or a person not ordinarily resident in India
- (F) The gross total income of an assessee having an OBU or an assessee being a Unit of an IFSC shall be deductible to the extent of 100% for 5 consecutive years from the year of grant of permission under the Banking Regulation Act / SEBI / other relevant law and 50% for the next 5 years¹². It further defines the exempted "income", which is:
- Income from an OBU in an SEZ ;
 - Income from business referred to in the Banking Regulation Act, 1949, or any other Unit which develops, develops and operates, or develops, operates and maintains an SEZ ;
 - Income from an approved unit of an IFSC.
- (G) Exemption from Securities Transaction Tax available to taxable securities transaction entered into by a non-resident through the IFSC.

OTHER BENEFITS

Customs and Excise

- *Exemption from Customs Duty:* SEZ Units may import or procure from the domestic sources, duty free, all their requirements of capital goods, raw materials, consumables, spares, packing materials, office equipment, DG sets etc. for implementation of their projects in the SEZ without requiring any licence or specific approval
- Goods imported/procured locally which are duty-free could or should be utilized within the approval period of 5 years

- Domestic sales by SEZ Units will be exempt from Special Additional Duty
- Domestic sale of finished products, by-products is permitted on payment of applicable Customs duty
- Domestic sale of rejects, waste and scrap is permitted on payment of applicable customs duty on the transaction value
- Exemption from applicable excise duty on goods brought in from the DTA to an SEZ

FOREIGN DIRECT INVESTMENT

- 100% FDI under the automatic route is allowed in the manufacturing sector in SEZ Units, except for arms and ammunition, explosives, atomic substances, narcotics and hazardous chemicals, distillation and brewing of alcoholic drinks and cigarettes, cigars and manufactured tobacco substitutes
- Exemption from the applicability of Press Note 2 (2005) that prescribes certain conditions that a foreign investor proposing to make foreign direct investment in real estate sector in India has to satisfy.

Banking / Insurance / External Commercial Borrowings

Setting up OBUs has been allowed in SEZs. External Commercial Borrowings by SEZ Units up to US\$ 500 million a year is allowed without any maturity restrictions

- Freedom to bring in export proceeds without any time limit
- Flexibility to keep 100% of export proceeds in an EEFC account and freedom to make overseas investments with it
- Commodity hedging permitted
- SEZ units allowed to 'write-off' unrealized export bills

Central Sales Tax

- Exemption from Central sales tax on inter-state sale or purchase of goods

Other Central Enactments

State Taxes

- The respective State Governments may for the purpose of giving effect to the provisions of the SEZ Act, notify policies for Developers and SEZ Units and take suitable steps for the enactment of any law for granting exemption from state taxes, levies and duties to a Developer or an entrepreneur

Service Tax

- Exemption from Service Tax to the Developer and the SEZ Units to carry on authorized operations in the SEZ. Service tax exemption granted only to Units in the DTA providing services to a Developer or to a Unit

Labour laws

All labour laws as applicable within the country apply in an SEZ.

Stamp duty

- No stamp duty is chargeable in respect of any instrument executed, by, or, on behalf of, or, in favour of, the Developer, or Unit or in connection with the carrying out of the purposes of the SEZ

Sub-Contracting

- SEZ Units may sub-contract part of their production or production process through Units in the DTA or through other EOU / SEZ Units
- SEZ Units may also sub-contract work from the DTA exporters, and export from the SEZ
- Units can be set up to provide manufacturing services to overseas entities subject to certain conditions

Transaction incentives with DTA

Any supplies from a DTA to an SEZ are to be treated as physical export. A DTA supplier would be entitled to:

- Drawback / DEPB
- Exemption from Central Sales Tax
- Exemption from State Levies
- Income-tax benefit as applicable to physical export under Section 80 HHC of the Income Tax Act.

CRITERIA FOR APPROVAL

Proposals for setting up SEZ in the public/private/joint/State sector are required to meet the following conditions:-

- (i) Minimum size of the SEZ shall not be less than 1000 hectares. This would however, not apply to existing EPZs converting into SEZs as such or for notifying additional area as a part of such SEZ or to product specific port/airport based SEZs.
- (ii) The SEZ and units therein shall abide by local laws, rules, regulations or bye-laws in regard to area planning, sewerage disposal,

pollution control and the like. They shall also comply with industrial and labour laws and such other laws/rules and regulations as may be locally applicable

- (iii) Such SEZ shall make adequate arrangements to fulfill all the requirements of the laws, rules and procedures applicable to such SEZ.
- (iv) Only units approved under the SEZ Scheme would be permitted to be located in these SEZ
- (v) At least 25 % area of the SEZ shall be used for developing industrial area for setting up of such units.

INDIA's POLICY ON SEZ- a Snapshot

- Developer of SEZ may import/procure goods without payment of duty for the development, operation and maintenance.
- Income tax exemption for a block of 10 year in 15 years at the option of developer as per section 80-IA of the Income Tax Act.
- Full freedom in allocation of developed plots to approved SEZ units on purely commercial basis.
- Full authority to provide services like water, electricity, security, restaurants, recreation centers etc. on commercial lines.
- Foreign investment permitted to develop township within the SEZ with residential areas, markets, play grounds, clubs, recreation centers etc.
- Develop Standard Design Factory (SDF) building in exiting Special Economic Zones.
- Income Tax exemption to Investor's in SEZ's under section 10 (23) G of Income Tax Act.
- Exemption from Service Tax Investment made by individuals etc.
- In SEZ company also eligible for exemption u/s 88 of IT Act.
- Development promoted to transfer infrastructure facility for operations and maintenance u/s 80-I-A of IT Act.
- Generation, Transmission and Distribution of Power in SEZs allowed.

CONCLUSION:

Government of India is seriously pondering over the concept of Investment Regions modeled on Pudong, Rotterdam and other successful ventures across the world to dot the map of India. To get the maximum possible leverage from the proposed investment in infrastructure, the Government of India has proposed to come up with a plan for setting up 5 or 6 such regions in India. The proposal being debated envisages a single mega industry led cluster that will have a planned network of high quality roads, air and sea ports and power plants connecting every industry and development area in a geographical area of 250-300 kilometers. It is also proposed to subsume the existing SEZs in such Investment Regions.

The establishment of the SEZs has undoubtedly helped to increase the volume of international trade. Further, a large amount of foreign investment has found its way not only into the export trade, but also into infrastructure construction and commerce. Foreign companies have been encouraged to establish their presence in the territories and the export industry has grown. Advanced foreign technology has been brought in with the inflow of foreign investment. All these factors have contributed to the growth of the Indian economy. The enactment of the SEZ Act and its implementation should enable the Government of India to fulfill its agenda of economic reforms as the multiplier effects on the economic activities triggered by SEZ materialize.

Disclaimer: This document is a copyright of Seth Associates. No reader should act on the basis of any statement contained herein without seeking professional advice. The authors and the firm expressly disclaim all and any liability to any person who has read this report, or otherwise, in respect of anything, and of consequences of anything done, or omitted to be done by any such person in reliance upon the contents of this report.

