



INDIA'S SPECIAL ECONOMIC ZONES

In April 2000, the Indian Government introduced a policy for setting up areas designated as “special economic zones” or “SEZs” with a view to promoting exports. The move followed the astounding success of the Chinese experiment with such zones in the Pearl River Delta and elsewhere.

Following the enactment of specific federal legislation in the year 2005, SEZs saw renewed interest from India’s industrial giants riding India’s economic boom, real estate players and foreign investors. Even in the prevailing gloomy global environment, India’s SEZ regime continues to remain an attractive proposition for industry and investors alike.

This *Atman Law* “Highlight” summarizes the key elements of the new regime.

Special Economic Zones may be broadly defined as geographical regions that have economic laws different from a country's typical economic laws. Starting with the Chinese experiment, special economic zones have been established in countries such as Iran, Poland, Kazakhstan, Philippines, Jordan and Russia.

In India, SEZs are specially delineated areas in which an industrial unit exporting goods and services can avail a number of benefits including exemptions from customs duties on import of machinery and various central and state tax benefits.



Legal Framework

Under the law, SEZs are deemed to be outside the customs territory of India. Goods and services coming into SEZs from the domestic tariff area or DTA are treated as exports from India and goods and services rendered from the SEZ to the DTA are treated as imports into India.

SEZs were initially established in India by virtue of certain changes in India's customs and tax laws in 2000. A new Chapter X-A on SEZs was inserted in the Customs Act, 1962 ("**Customs Act**"). Separate guidelines were also issued under India's tax law and provided for tax benefits to SEZs established in accordance with the guidelines.

In the following years, several Indian states, including Uttar Pradesh, West Bengal, Madhya Pradesh, Maharashtra and Rajasthan enacted laws specifically governing SEZs in their states.

In 2005, the Special Economic Zones Act, 2005 ("**SEZ Act**") was passed by the Union Parliament and was brought into force on March 14, 2006, this being the date on which the provisions of Chapter X-A of the Customs Act ceased to have effect.

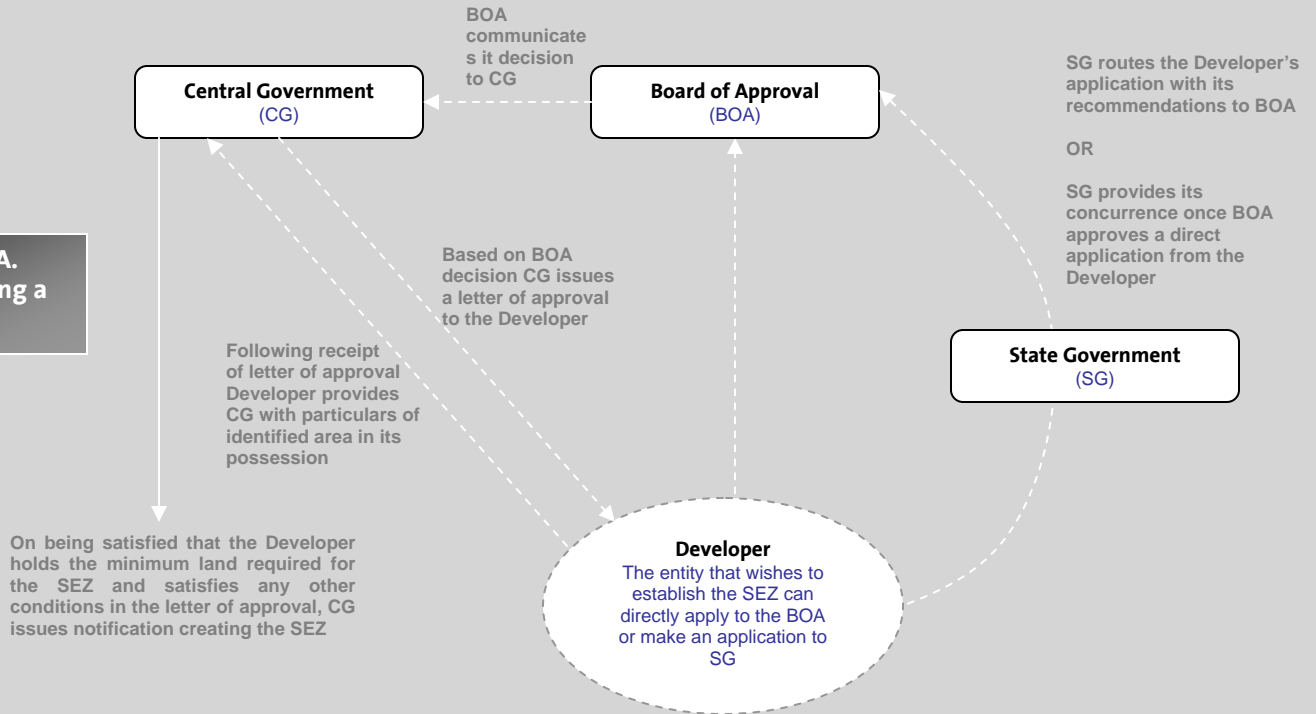
The SEZ Act purports to be a comprehensive law for the establishment, development and management of SEZs for the promotion of exports. It provides for the constitution and functions of different authorities, namely the Board of Approval, Approval Committee, the SEZ Authority and the Development Commissioner.

Being a law enacted by Parliament, the SEZ Act can only deal with matters constitutionally reserved for the Union exclusively or matters that may be legislated on by the Union concurrently with the States.

SEZs are intended to be large swathes of contiguous land to be developed as self-contained townships with industrial, commercial and residential development. Issues such as town planning, regulation of industries are matters constitutionally reserved for legislation by State legislatures and the states have laws that govern these matters.

While the SEZ Act provides a framework for the establishment of territories which are subject to more favourable provisions under various central laws (such as income tax, customs and excise) and the terms and conditions governing the applicability of these favourable provisions, it also recognizes that such territories are subject to state laws and authorities and additional legislation may be required to be introduced

**Figure A.
Establishing a
SEZ**

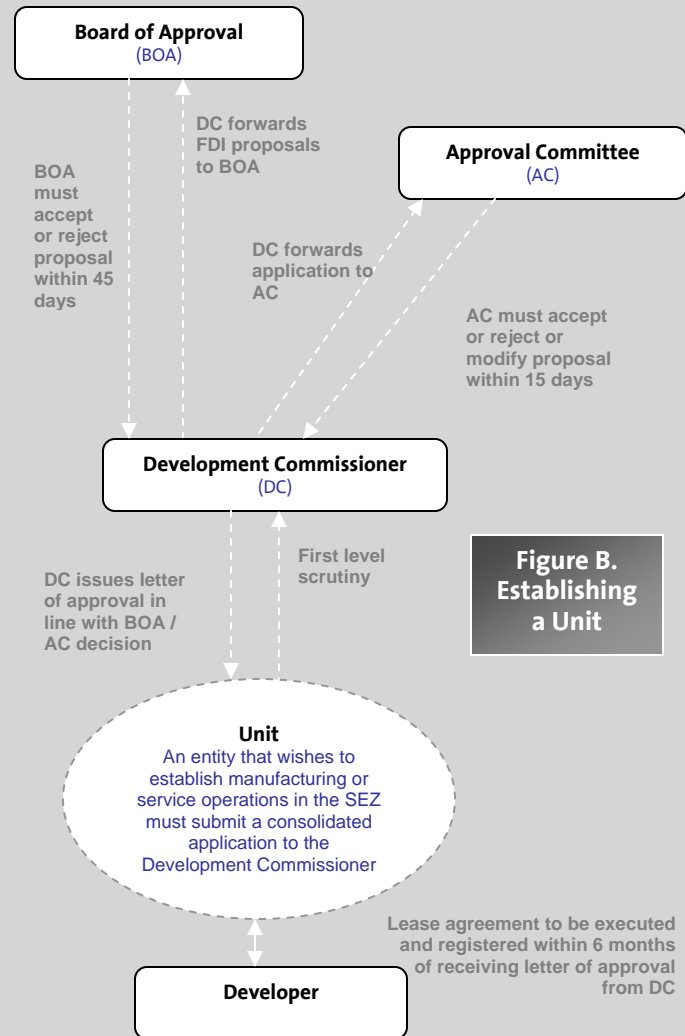


by the states to give full effect to the intent of the SEZ Act. The SEZ Act deals primarily with the following matters:

- ▶ Establishment of the SEZ and the various authorities constituted in this connection
- ▶ Appointment of the Developer, Co-developers and approval for units to be located in the notified area
- ▶ exemptions, drawbacks and concessions including exemptions from customs duty (on goods brought into or exported from the SEZ), excise, service tax, securities transaction tax, sales tax and income tax
- ▶ *Offshore Banking Unit & International Financial Services Centre.* Setting up of offshore banking units / International Financial Services Centre in SEZs
- ▶ *Notified Offences & Civil Suits.* A single enforcement agency/officer for certain notified offences as well as the designation of courts by the state governments for such offences committed in and for civil suits arising in SEZs

Section 50 of the SEZ Act provides that State governments may for the purposes of giving effect to the provisions of the SEZ Act, notify policies and take steps for enactment of any law granting exemptions from state taxes and delegating powers under State enactments to the development commissioner appointed under the SEZ Act.

Figures A and B provide an overview of the process of establishing a SEZ and a unit within a SEZ, respectively.



**Figure B.
Establishing
a Unit**

SEZ BENEFITS

The SEZ Act provides a number of benefits to Developers and to Units. The key benefits are summarized below:

- ▶ A tax holiday to the Developer for any ten consecutive assessment years in a block of fifteen years from the date in which the SEZ is notified
- ▶ exemption from paying tax on distributed profits
- ▶ exemption from paying minimum alternative tax
- ▶ exemption from customs duty on imported goods required by the Developer for carrying on authorized activities within the SEZ
- ▶ exemption from customs duty on goods exported from a SEZ to any place outside India
- ▶ exemption from payment of excise duty on the supply of goods to an SEZ to carry on authorized activities
- ▶ exemption from service tax for services procured by the Developer to carry on authorized activities within the SEZ
- ▶ exemption from central sales tax on the procurement of SEZ goods by the Developer from the DTA, for carrying out authorized activities within the SEZ
- ▶ SEZ Unit entitled to tax benefits for 15 years beginning with the assessment year relevant to the previous year in which the Unit begins to manufacture or produce such articles or things or provide services
- ▶ SEZ Units can import goods duty free import from domestic sources for capital goods, raw materials, consumables, packing materials, office equipment, DG sets, etc. for development, maintenance and operations in the SEZ.

TABLE A. MINIMUM AREA REQUIREMENTS UNDER THE SEZ ACT

Type of SEZ	Minimum Land	Contiguous	Minimum Built up Area (square meters)	Minimum Processing Area
Multi Product SEZ	1000 hectares (2500 acres)		None	25 per cent
Sector Specific SEZ	100 hectares (250 acres)		None	50 per cent
SEZ in a port or airport	100 hectares (250 acres)		None	50 per cent
IT/ITES SEZ	10 hectares (25 acres)		100,000	50 per cent
Biotech SEZ	10 hectares (25 acres)		None	50 per cent
SEZ for non-conventional energy	10 hectares (25 acres)		None	50 per cent
SEZ for gem/jewellery	10 hectares (25 acres)		None	50 per cent
SEZ for free trade or warehousing	40 hectares (100 acres)		100,000	50 per cent

Significant Requirements, Conditions and Restrictions under the SEZ Act and Rules

To be notified as an SEZ, the area identified by the applicant must meet certain minimum land requirements (See Table A)

IT SEZs and Trade & Warehousing SEZs must satisfy certain built up area requirements (See Table A) although the time period for complying with this condition is unclear

While the SEZ law envisages residential and commercial development within the SEZ, certain minimum area (See Table A) called the processing area must be set aside (and fenced) for the manufacturing/services units.

entities other than the Developer can undertake development of residential, commercial and recreational facilities only if the Developer has a 26% equity stake in such entities

Sale of land within an SEZ is prohibited

Lease of land to units within an SEZ requires a letter of approval

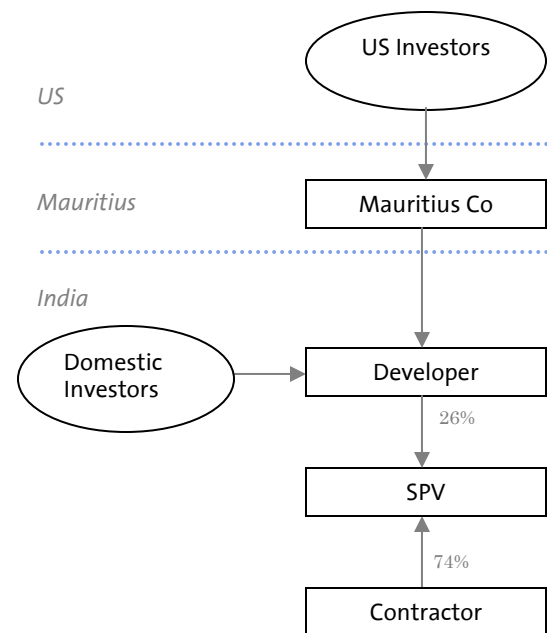
Sales to DTA by SEZ units to be treated as import and shall be chargeable to customs duties where applicable as leviable on such goods when imported

FOREIGN INVESTMENT IN SEZs

The enactment of the SEZ Act read with Press Note 4 of 2006 has given rise to a degree of uncertainty regarding the procedures and conditions governing foreign direct investment in a Developer or in SEZ units.

That said, the structures for investing in an SEZ are fairly straightforward and follow the well-worn path of a holding company (for overseas investors) in a tax-favorable jurisdiction such as Mauritius, as set out in Figure C.

The Developer attracts significant tax benefits and for this reason is the preferred investee entity. The Developer can farm out development of different parts or phases of the SEZ to contractors by setting up SPVs (in which the Developer must mandatorily hold a 26 percent stake).



ADVANTAGES

- ▶ US Investors are insulated from direct restrictions on transfer that may be imposed at the Developer level. Exits by way of share sale to another US investor are easier
- ▶ tax benefits apply to income earned by the Developer
- ▶ Shareholders benefit from exemption from tax on dividend distribution

DISADVANTAGES

- ▶ Investment cannot be targeted to specific projects within the SEZ without significant complexity in transaction documents and governmental clearances
- ▶ Returns only on longer term basis since initial internal accruals will typically need to fund initial phase of SEZ development

If you have any questions regarding the subject matter of this Highlight, please contact Vivek Durai at vivek.durai@atmanlaw.com. This Highlight is issued for informational purposes only and is not intended to be construed or used as general legal advice.