

Issues under Income-tax - SEZ & IFSC

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Arpit Jain



Background and Tax Incentives

Special Economic Zones (SEZ)

- Governed by Special Economic Zones Act 2005
 - SEZ laws first introduced in India in 2000
 - Contours similar to Free Trade Zones, Export Processing Zones, etc.
- Designated special areas with liberal regulatory provisions compared to domestic areas
- To promote foreign investments and exports
- 357 SEZs notified under SEZ Act as on September 11, 2020 with 5476 units as on June 30, 2020
 - 255 Operational SEZs as on June 30, 2020
- Various benefits under direct and indirect tax laws
 - Income-tax benefits phased out with sunset clauses, many indirect tax benefits continue

SEZ - Income-tax Benefits

For SEZ Developers

□ Section 80-IA

- Undertaking which develops, develops and operates or maintains and operates an industrial park or special economic zone notified by Central Government during April 1, 1997 to March 31, 2006
- 100% exemption for profits from eligible business of the undertaking for 10 out of 15 AYs
 - AY 2020-21 to be last year for deductions u/s 80-IA for undertakings that commenced business in AY 2006-07

□ Section 80-IAB

- 100% of profits from business of development of SEZs for 10 out of 15 AYs
 - From date of notification of SEZ
 - Deductions for unexpired period in hands of transferee where O&M of SEZ is transferred by developer
- Development to commence on or before March 31, 2017

Sunset clauses already expired

SEZ - Income-tax Benefits

For SEZ Units

□ Section 10AA

- Profit linked Incentive to the Units in SEZ
- Eligible Activity
 - Manufacture or produce article or things
 - Provide any services
- Eligible Period – commencement of activity during April 1, 2005 to March 31, 2020
 - Extended to March 31, 2021 if Letter of Approval was received on or before March 31, 2020
 - Amendment carried out through The Taxation And Other Laws (relaxation and amendment of certain provisions) Bill, 2020 passed in Rajya Sabha on Sept 22, 2020
- Deduction from total income in 3 phases (from the year in which activity begins) –
 - 100% of export profits for Year 1 - 5
 - 50% of export profits for Year 6 - 10
 - Up to 50% of profits credited to SEZ Reinvestment Reserve for Year 11 - 15

SEZ - Income-tax Benefits

- Conditions for credit to SEZ Re-investment Reserve
 - Profits credited to SEZ Re-investment Reserve Account and utilized for acquiring plant & machinery for business of SEZ unit
 - Plant & machinery is put to use within 3 years from year in which reserve is created
 - Reserve not to be utilized for dividend distribution or repatriation of profits outside India or creation of assets outside India (until it is utilized for acquiring plant & machinery)
- Deduction to be allowed from Total Income
 - Computed without giving effect to the Provisions of Section 10AA
 - And it shall not exceed the Total Income

SEZ - Income-tax Benefits

For Offshore Banking Unit in SEZ

- Income-Tax Holiday – Deduction u/s 80-LA
 - 100% profits for 5 years & 50% of profits for subsequent 5 years
 - No Sunset clause

International Financial Services Centre (IFSC)

- IFSC - Specialised category of SEZ for financial services sector
 - Banking, capital markets, insurance and other financial services
- GIFT City – first IFSC in India
- Various exemptions / waiver from
 - Income-tax
 - Capital gains tax
 - Security Transaction Tax(STT)
 - Commodity Transaction Tax(CTT)
 - Customs and Good & Services Tax
 - Stamp duty exemptions by State Government

IFSC – Income-tax Incentives

For IFSC Unit

- Income-Tax Holiday – Deduction u/s 80-LA
 - 100% profits for 10 years out of 15 AYs
 - From year in which registration / regulatory approval is obtained
 - No Sunset clause
- MAT and AMT reduced to 9% plus surcharge & cess [instead of 18.5%+]
- Section 80LA benefit available u/s. 115BAA as well
 - Option to reduced rate of 22% plus surcharge and cess
 - If that is opted, MAT will not be applicable altogether
- No Tax on Dividend
 - No DDT on IFSC Unit
 - Deriving income only in convertible foreign exchange
 - For income generated after April 1, 2017
 - No dividend tax in hands of recipient shareholders [Section 115-O(8)]



Income-tax Issues

Offshore Banking Units and IFSC Units

- ❑ **Issue 1 – Offshore Banking Unit and IFSC Units – Sec. 10AA vs Sec 80LA**
- ❑ Whether an overlap?
 - “Services” (term used in section 10AA) as defined under SEZ Law also include Offshore Banking Services
 - Section 10AA refers to “Unit” as defined under SEZ Law
 - ❑ Definition of “Unit” includes normal Units, OBU Units and IFSC Units same as in SEZ Law
 - Intended or unintended?
- ❑ Specific over general?
- ❑ Which provision is more beneficial?
- ❑ Deduction to be chosen at the option of the taxpayer?

Offshore Banking Units and IFSC Units

- Both provisions introduced by SEZ Act 2005
 - Intended
- Definition of “Unit” under SEZ Law
 - Specific separate references to OBUs and IFSC Units – one can draw an inference
- Separate governing provisions under SEZ Law
 - Unit by an Entrepreneur – Section 15
 - OBU – Section 17
 - IFSC – Section 18
- Section 10AA refers to Unit of an Entrepreneur – a possible reference to section 15 of SEZ Law
- Conclusion
 - Section 10AA – Units in SEZ other than OBUs and Units in IFSC
 - Section 80LA – OBUs and Units in IFSC

Dividends

- ❑ **Issue 2 – Abolition of DDT vis-à-vis withdrawal of exemption u/s 10(34) in hands of shareholders**
- ❑ **Section 115-O(8) – Specific exemption to IFSC Units**

*“8) Notwithstanding anything contained in this section, no tax on distributed profits shall be chargeable in respect of the total income of a company, being a unit of an International Financial Services Centre, deriving income solely in convertible foreign exchange, for any assessment year on any amount declared, distributed or paid by such company, by way of dividends (whether interim or otherwise) on or after the 1st day of April, 2017, out of its current income 91[or income accumulated as a unit of International Financial Services Centre after the 1st day of April, 2017], either in the hands of the company **or the person receiving such dividend**”*

Dividends

- Sec. 10(34) as amended

“any income by way of dividends referred to in section 115-O:

Provided that nothing in this clause shall apply to any income by way of dividend chargeable to tax in accordance with the provisions of section 115BBDA;

Following second proviso shall be inserted after the first proviso to clause (34) of section 10 by the Finance Act, 2020, w.e.f. 1-4-2021:

Provided further that nothing contained in this clause shall apply to any income by way of dividend received on or after the 1st day of April, 2020 other than the dividend on which tax under section 115-O and section 115BBDA, wherever applicable, has been paid”

- Whether section 115-O(8) continues to prevail?
- Can 115-O(8) can override 10(34)? – Which section provides an exemption?
- Memorandum explaining Finance Bill 2020

Profits eligible for deduction

- **Issue 3** – Which profits / incomes are eligible for deduction?
 - Supreme Court in case of Liberty India 317 ITR 218 (SC) held as under -
 - the phrase 'derived from' has narrower connotation than 'attributable to'
 - Parliament intended to cover sources not beyond the first degree
 - Question is - whether the particular income comes within the first degree sources?
 - Section 10AA as well as Section 80IAB both uses the phrase 'derived from'
 - Whether the incidental income would be eligible for deduction u/s. 10AA / 80IAB?
 - Foreign Exchange Fluctuation
 - Interest income on deposits / advances for business purpose (Electricity Deposit, FD for LC purpose, supplier advance, delayed customer realization, etc.)
 - Liquidated damages for breach of contractual obligations
 - Subsidies and incentives (for export or otherwise like DEPB, Drawback, etc.)

Profits eligible for deduction

80-IAB. (1) Where the gross total income of an assessee, being a Developer, includes any profits and gains derived by an undertaking or an enterprise from any business of developing a Special Economic Zone, notified on or after the 1st day of April, 2005 under the Special Economic Zones Act, 2005, there shall, in accordance with and subject to the provisions of this section, be allowed, in computing the total income of the assessee, a deduction of an amount equal to one hundred per cent of **the profits and gains derived from such business** for ten consecutive assessment years:

10AA. (1) Subject to the provisions of this section, in computing the total income of an assessee, being an entrepreneur as referred to in clause (j) of section 2 of the Special Economic Zones Act, 2005, from his Unit, who begins to manufacture or produce articles or things or provide any services during the previous year relevant to any assessment year commencing on or after the 1st day of April, 2006, but before the first day of April, 2021, the following deduction shall be allowed—

- (i) hundred per cent of **profits and gains derived from the export**, of such articles or things or from services for a period of five consecutive assessment 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, as the case may be, and fifty per cent of such profits and gains for further five assessment years and thereafter...

Profits eligible for deduction

- Income from operations of eligible business or incomes having first degree nexus to be eligible
 - Liquidated damages received from suppliers due to delays / non-performance
 - Eligible - Hubli Electricity Supply Co. [2018] 404 ITR 462 (Karnataka)
 - Not eligible - CIT v. Alpine Solves Ltd 144 Taxmann 67 (MP)
 - Interest on Electricity Deposit
 - Not Eligible - Pandian Chemicals Ltd v. CIT 129 Taxmann 539 (SC)
 - Duty drawback / DEPB benefits
 - Not Eligible - Liberty India 317 ITR 218 (SC) / Orchev Pharma 210 Taxmann 236 (SC)
 - Sale of Import Entitlement
 - Not Eligible - CIT v. Sterling Foods [1999] 104 Taxmann 204 (SC)
 - Interest from trade debtors
 - Eligible - Nirma Ltd [2006] 283 ITR 402 (Gujarat) and Nirma Ktd. [2015] 229 Taxman 577 (Gujarat)
 - Commission [and service income]
 - Not Eligible - Indian Additives Ltd. 25 taxmann.com 412 (SC)

First degree nexus – Factual Exercise

Profits eligible for deduction

- Section 80-IAB has been drafted in a manner similar to Section 80-IA
 - Hence, the Supreme Court ruling in case of Liberty would apply to Section 80-IAB
- However, Section 10AA(7) is worth noting
 - (7) For the purposes of sub-section (1), the **profits derived from the export** of articles or things or services (including computer software) **shall be the amount** which bears to the **profits of the business of the undertaking**, being the Unit, the same **proportion as the export turnover** in respect of such articles or things or services **bears to the total turnover** of the business carried on by the undertaking

Profits eligible for deduction

- 'profits derived from export' is defined through mathematical formulae in Section 10AA
 - Rulings in context of Section 80-IA would not be applicable in case of Section 10AA
 - The formulae is more akin to formulae given u/s. 10A / 10B
 - All items that can be regarded as 'profits of the business of the undertaking' can be included even if it is 'not derived from export'
- The income should be 'of business' and not necessarily 'derived from exports'
 - Asiatic Colour Chem Inds. Ltd. Vs. The ACIT(OSD) Range -I (ITA no. 551 & 553) (TAHD)
 - ACIT Vs. Motorola India Electronics (P.) Ltd. 112 TTJ 562 (TBAN) 2007
 - Hindustan Gum & Chemicals Ltd. Vs. ITO, Ward-12(4), Kokata. 23 SOT 143 (TCAL) 2008
- Income chargeable as 'Income from other Sources' would still not be eligible
- Section 80LA also refers to Income from business of OBU / IFSC
 - Therefore, all the income of OBU / IFSC with nexus to business should be eligible for deduction

Profits eligible for deduction

□ **Issue 4** – For Year 11 to 15, whether deduction is restricted to 50% of export profits only?

10AA. (1) Subject to the provisions of this section, in computing the total income of an assessee, being an entrepreneur as referred to in clause (j) of section 2 of the Special Economic Zones Act, 2005, from his Unit, who begins to manufacture or produce articles or things or provide any services during the previous year relevant to any assessment year commencing on or after the 1st day of April, 2006, but before the first day of April, 2021, the following deduction shall be allowed–

- (i) hundred per cent of **profits and gains derived from the export**, of such articles or things or from services for a period of five consecutive assessment 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, as the case may be, and fifty per cent of such profits and gains for further five assessment years and thereafter;
- (ii) for the next five consecutive assessment years, so much of the amount not exceeding fifty per cent of **the profit** as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Re-investment Reserve Account") to be created and utilized for the purposes of the business of the assessee in the manner laid down in sub-section (2)

Profits eligible for deduction

- Section 10AA(7) reads as under -
 - (7) For the purposes of sub-section (1), **the profits derived from the export** of articles or things or services (including computer software) shall be the amount which bears to the profits of the business of the undertaking, being the Unit, the same proportion as the export turnover in respect of such articles or things or services bears to the total turnover of the business carried on by the undertaking
- Section 10AA(2) & (3) deals with utilization / non-utilization of SEZ Investment Reserves and hence they don't apply in the instant case

Profits eligible for deduction

- **Issue 5** – Onshore software development profits – whether subject to formulae?
 - Section 10AA considers software development as services and therefore export thereof is eligible for benefit u/s. 10AA
 - Normally, the profits in onshore software development are higher than in offshore software development
- If services are rendered outside India, can it be regarded as export?
- Whether onshore software development profits also need to be blended based on formulae given in Section 10AA(7)?

Profits eligible for deduction

- Explanation 2 to Section 10AA provides as under -
 - *Explanation 2.—For the removal of doubts, it is hereby declared that the **profits and gains derived from on site development of computer software** (including services for development of software) outside India **shall be deemed to be the profits and gains derived from the export** of computer software outside India.*
- Activities are not deemed as ‘exports’
 - But the profits themselves are deemed as ‘profits derived from export’
 - Which is eligible for deduction u/s. 10AA(1)

Section 10AA – Eligible business activity

- ❑ **Issue 6** – Whether trading eligible for benefit of Section 10AA?
- ❑ Manufacture or production or services are eligible
- ❑ Manufacture is to be interpreted as used in SEZ Act
 - Sec. 2(r) of SEZ Act “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 and shall include processes such as refrigeration, cutting, polishing, blending, repair, remaking, re-engineering and includes agriculture, aquaculture, animal husbandry, floriculture, horticulture, pisciculture, poultry, sericulture, viticulture and mining
- ❑ Can ‘trading’ be regarded as services?
 - Services not defined u/s. 10AA

Section 10AA – Eligible business activity

- Rule 76 of SEZ Rules considers ‘trading’ as services
 - However, for the purpose of Income tax benefit, restricted meaning is given
- Trading in nature of import for re-export fall within ambit of ‘services’ for IT purpose
 - Goenka Diamond & Jewellers Ltd. [2012] 146 TTJ 68 (Jaipur)
 - Solitaire Diamond Exports [2020] 182 ITD 474 (Mumbai - Trib.)
 - Midas DFS (P.) Ltd. [2018] 96 taxmann.com 351 (Kolkata - Trib.)

Export Profits

❑ Issue 7 – Sales from one SEZ Unit to another SEZ Unit – whether Export?

❑ Sec. 2(m) of SEZ Act

▪ Export means

- ❑ taking goods, or providing services, out of India, from a SEZ by land, sea or air or by any other mode, whether physical or otherwise; or
- ❑ supplying goods, or providing services, from Domestic Tariff Area to a SEZ Unit or Developer; or
- ❑ supplying goods, or providing services, from one Unit to another Unit or Developer, in the same or different Special Economic Zone

❑ Sec. 10AA

▪ Export means

- ❑ taking goods or providing services out of India from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise

Export Profits

- Since export has been specifically defined u/s. 10AA, the said meaning shall prevail over meaning given under SEZ Act
 - Sarto Electro Equipment P.Ltd ITA 3127/Mum/2014

Set off of Losses

- ❑ **Issue 8** – Are losses of other undertakings (eligible / ineligible) to be set off against profits of eligible unit?
- ❑ Section 80-IA & 80-IAB
 - Section 80-IA(5) – Undertaking considered separate
 - ❑ Set off of losses & unabsorbed depreciation of losses of eligible unit essential from Initial AY
 - ❑ Initial AY – Year of commencement vs year when deduction first claimed?
 - While undertakings are considered separate, deduction to be computed taking into consideration losses of other units since deduction is wrt Income included in Gross Total Income which is derived after offsetting losses of other units
 - ❑ Profit derived from one industrial undertaking should be adjusted against loss suffered in another undertaking
 - [Sintex Industries Ltd. \[2013\] 37 taxmann.com 217 \(Gujarat\)](#)

Set off of Losses

- Possible to argue that since Section 10AA is included in Chapter III and not Chapter VI, offset of losses from ineligible units not required
- Effect of Amendment to Section 10AA vide Finance Act 2000
 - “profits and gainsshall not be included in the total income of the assessee” to “a deduction of such profits and gains..... shall be allowed from the total income of the assessee”
- In context of Se. 10A held that even after 1-4-2001, section 10A provides for an exemption (and not deduction)
 - Despite of provisions of Sec. 80A(4), profits of ineligible unit not to be set off against profits of Sec. 10A unit
 - ‘Total income’ in Sec. 10A refers to ‘Total income of the undertaking’ and not ‘Total income of the assessee’
 - Yokogawa India [2012]341 ITR 385 (Kar);
 - TEI Technologies (P) Ltd [2012] 25 Taxmann.com 5 (Del)

Set off of Losses

- CBDT Circular No. 7 dated July 16, 2013
 - Deduction to be allowed after set-off of losses of other units
- Explanation to Section 10AA(1)
 - For the removal of doubts, it is hereby declared that the amount of deduction under this section shall be allowed from the total income of the assessee computed in accordance with the provisions of this Act, before giving effect to the provisions of this section and the deduction under this section shall not exceed such total income of the assessee.
- Since amendment to section 10AA takes effect only from 1-4-2018, set-off not mandatory for period prior to that
 - Cosmo Films Ltd. [2019] 108 taxmann.com 49 (Delhi)

Voluntary TP Adjustments

□ Issue 9 – Voluntary TP adjustments and deductions

□ Section 92C(4)

Where an arm's length price is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined:

Provided that no deduction under section 10 or section 10AA or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section.

□ Whether deduction u/s 10AA / Chapter VI-A will be available in the following circumstances?

- A taxpayer makes a suo moto adjustment and considers the same in computation of income
 - What if adjustment is made in books of accounts and money is received?
 - What if money is not received?

Voluntary TP Adjustments

- Section 92C(4) deals with actions of AO in case of enhancement of as a result of TP adjustment
 - Voluntary adjustments would not result in enhancement of total income in the process of TP Assessment
- Voluntary TP adjustments suo moto made by assessee in return of income allowed as deduction u/s 10AA
 - Voluntary adjustment not adjustment made by AO u/s 92C
 - EYBGS India (P.) Ltd. [2020] 117 taxmann.com 294 (Bangalore - Trib.)
 - GS Engineering & Construction India Private Limited v/s ACIT (ITA No. 3956/DEL/2014)
 - iGate Global Solutions Ltd. vs/ ACIT (2008) 24 SOT 3 (Bang)
- Suo moto TP adjustments subject to secondary adjustments u/s 92CE wef FY 2017-18,
- TP adjustments > rupees one crore to be repatriated into India within 90 days of due date of filing of tax return
 - Amounts not so repatriated treated as deemed advance and require imputation of interest thereon

Plough back of Profits

❑ Issue 10 – Creation of and utilization from SEZ Re-investment Reserve Account

❑ Section 10AA(2)

“The deduction under clause (ii) of sub-section (1) shall be allowed only if the following conditions are fulfilled, namely:-

- (i) For the purpose of acquiring machinery or plant which is first put to use before the expiry of a period of three years following the previous year in which the reserve was created; and*
- (ii) Until the acquisition of the machinery or plant as aforesaid, for the purposes of the business of the undertaking other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India”*

❑ When can reserve be created?

- Year-end vs. periodic basis

❑ Whether creation and utilization in the same year possible?



Thank You!