

## Special Economic Zones versus Software Technology Parks – A Critical Analysis

### Introduction

The Special Economic Zones (“SEZ”) were introduced in India in 2000 in order to provide a level playing field to the domestic enterprises and manufacturers, so that they could compete with the global players. The SEZs are a separate, demarcated region governed by economic laws that are more liberal than the typical economic laws. A SEZ unit provides companies with tax exemptions, and business incentives, which in turn promote Foreign Direct Investment (“FDI”) and technology into the country. The SEZs cater to multiple industries. They can be sector specific or multi-product. Sector specific SEZs are exclusively meant for one or more products or services in one sector. In contrast, multi-product SEZs cater to units set up for manufacture or rendering of services of two or more goods/services in a sector or goods/services falling in two or more sectors. Today, India has more than 600 units<sup>1</sup> with over three hundred thousand employees.

Unlike the SEZ, the Software Technology Parks (“STP”) are export oriented units which concentrate only on computer software and services related to them. They were established with the aim of providing the necessary impetus for development and export of computer software and professional services. The STPs have boosted the export of software and services, and is one of the reasons why India is recognized as an Information Technology superpower.

This newsletter aims to compare the incentives provided by each, SEZ and STP, and attempts to throw light on the effect the “sunset” clause shall have on small and mid-size enterprises (“SME”).

### 1.0 Comparison of SEZ versus STP

While comparing the incentives offered by each, it has to be kept in mind that the STPs are sector specific. They only facilitate to the needs of the computer software market. As for the SEZs, they cater to a variety of industries, ranging from gems and jewelry to electrical appliances, and even computer software.

### 1.1 Incentives offered by SEZs and STPs

To promote investments from domestic and foreign sources, the central government granted exemptions and gave incentives to developers and entrepreneurs interested in developing a SEZ, establishing a unit in a SEZ or STP. Both SEZs and STPs offer a wide range of incentives, the important ones are covered below.

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<sup>1</sup> <http://sezindia.nic.in/writereaddata/pdf/ListofoperationalSEZs.pdf> visited on January 20, 2010

**1.1.1 Income Tax:** Units in a SEZ are granted income tax exemptions for a period of 15 years from the time they begin to manufacture or provide services viz., 100% income tax exemption for the first 5 years, 50% for the 5 years thereafter, and 50% of the reinvested profits subsequently.<sup>2</sup> As compared to SEZ, STP units are granted only 90% deduction on exports turnover.<sup>3</sup> Furthermore, it is pertinent to note that this exemption had been initially granted in the form of a 10 years tax holiday and since the financial year 2008-2009, this exemption is extended on an annual basis. As such, this exemption is currently valid only until March 31, 2010. It is likely that the government will extend this exemption for a further one year period. However, it is speculative and also subject to the proposed changes suggested in the Direct Tax Code (“DTC”).

**1.1.2 Minimum Alternative Tax (“MAT”):** MAT is the tax levied on companies which declare large dividends and profits but do not pay income tax due to various exemptions provided in the Income Tax Act, 1961 (“IT Act”).<sup>4</sup> SEZ units are completely exempt under the IT Act; however, this exemption is not granted under STPs. MAT is levied at 15% of the book profits attributable to STP sales to domestic customers.<sup>5</sup>

**1.1.3 Dividend Distribution Tax (“DDT”):** Dividends are tax-exempt in the hands of resident and non-resident shareholders of an Indian company. But, the company declaring the dividends is required to pay an additional corporate tax or DDT at the rate of 15%. This DDT is not a withholding tax, and means that the benefit of lower withholding tax rates provided under the Double Taxation Avoidance Agreement between India and other countries may not be available. While companies who have established units in SEZs are granted exemption from payment of DDT, this incentive is not offered under the STP scheme and tax is levied at 16.995% (inclusive of education cess and surcharge) on the dividend declared by STP units.

**1.1.4 Service Tax:** Units under SEZ are exempt from paying service tax for the services which are consumed within the SEZ. For services provided or consumed partially or outside SEZ, an exemption, in the form of a refund, is granted. As for STP units, they are entitled to Central Value Added Tax (“CENVAT”)<sup>6</sup> credit on service tax paid on supplies brought in from the Domestic Tariff Area (“DTA”) which is effectively the whole of India other than the areas of SEZs.

**1.1.5 Value Added Tax and Central Sales Tax:** Units in a SEZ are exempted from payment of these taxes on goods purchased from the DTA. Exemption, in the form of reimbursement, is available to STP units. This means that a unit in an STP has to make that payment first, and then claim it back.

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<sup>2</sup> Section 10AA of the Income Tax Act

<sup>3</sup> Section 10A of the Income Tax Act

<sup>4</sup> Section 115JB(6) of the Income Tax Act

<sup>5</sup> Section 115JB of the Income Tax Act

<sup>6</sup> A manufacturer or producer of final product is allowed to take CENVAT credit of duties specified in the CENVAT Credit Rules, 2002

**1.1.6 Central Excise Tax and Customs Duty:** Goods brought from the DTA to a SEZ or a STP unit is exempt from any duty of excise, provided they are used to carry out the authorized operations. SEZs as well as STPs are exempt from paying customs duty on goods or services that are imported.

**1.1.7 Sales to DTA:** Apart from the added benefits of exports, SEZs and STPs are also permitted to sell goods or provide services in the DTA. While there is no limit for DTA sales made by a SEZ unit, subject to payment of applicable duties SEZ units are allowed to make sales in DTA on payment of import duties, STP units are only permitted up to 50% of the Free on Board value of exports.

## **1.2 Drawbacks of SEZs and STPs**

### **1.2.1 Drawbacks of SEZs**

The SEZ offers various incentives to developers as well as entrepreneurs. A significant feature of SEZs is the fact that they are usually located on the outskirts of the cities. In order to avail exemptions, companies, both SME or larger ones, will have to move from the DTA to the SEZ. This move is likely to affect the SMEs more than the larger companies. For instance, the area required to build a SEZ ranges from 10 hectares to 1,000 hectares.<sup>7</sup> SMEs will, in all probability, lack the fiscal strength to establish an entire SEZ, and will, potentially, look to form a unit within the SEZ. This too may act as a hurdle because the influx of companies within SEZs has created a high demand, low supply condition leading to escalated land prices. As a consequence, competition to establish units is exceedingly high. Companies with strong balance sheets and financial capabilities find it easier to generate the funds, either through equity or debt, for capital expenditure involved in a new investment that will, ultimately, prove to be beneficial. SMEs may not have such easy access to funds to establish units within a SEZ, and may not want to incur the significantly higher costs involved in establishing and relocation to a unit within a SEZ. The government needs to consider the possibility of demarcating land catering only for the SMEs so that they too can avail of the benefits the scheme has to offer.

### **1.2.2 Drawbacks of STPs**

Comparing the incentives granted to SEZ with those to STP, it is quite evident that the exemptions provided to the STP are not at par with those provided to SEZ. The tax concessions including the exemption of MAT, DDT and capital gains tax are available only in a SEZ. A STP unit also has certain minimum export obligation to fulfill for 5 years viz., US \$ 0.25 Million or 3 times the Cost in Freight value of imported goods, whichever is higher.

As far as sales in the DTA i.e., the area within India but outside the SEZ or STP is concerned, it appears that although both SEZ and STP units may sell goods or services to the DTA, a STP unit is permitted to sell only up to 50% of the FOB value of its exports into the DTA on fulfillment of specified conditions.

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<sup>7</sup> Rule 5 of the Special Economic Zones Rules, 2006

With regard to the location, while STP units may be located anywhere, there is a requirement to carry out their operations in a custom bonded area.<sup>8</sup> As such, the unit has to individually seek a private bonded warehouse license.

However, most significant is the fact that the concessions in a STP have a sunset clause of March 31, 2010. The units established in STPs have been particularly concerned about the possibility of these exemptions being brought to an end.

## Conclusion

On the basis of comparison of the drawbacks for both SEZs and STPs, it is perceptible that the advantages are greater for SEZs viz., higher income tax exemptions, more indirect tax exemptions or the capability to support exports to the DTA as well. However, apart from the above, it is also pertinent to note that the concerns are different depending upon the scale and activity of the companies. While large well established companies would prefer SEZs since they have the financial capability to undertake large scale operations, SMEs have typically preferred to take the route of STPs. This has allowed them to be located in any jurisdiction with low administrative costs and additionally reap the benefits of STPs.

Furthermore, since the SEZs provide the unit with a wider scope for flexibility in its activities, as opposed to STPs which are restricted to IT and IT enabled services, companies with a varied scope of operations would, in general, prefer SEZs.

However, in view of the significant feature of the sunset clause in STPs and the wide speculation of these exemptions coming to an end, it would be prudent for SMEs to assess whether it would be sensible for them to consider either establishing themselves right at the outset in SEZs for new companies or shifting from STPs to SEZs in case of companies already established in STPs.

Finally, recently the Central Government released the draft DTC which is intended to replace the IT Act for all purposes by financial year 2011-12. The draft DTC is silent on the tax holiday and exemptions that had been provided to the SEZ and STP units; however, the presumption is that the income tax exemptions that are currently available to SEZ and STP units may be taken away. It is pertinent to note that as of now, the DTC is in draft form and no clear clarifications have been stipulated by the Central Government.

## Authored by:

*(This E-Newsline is prepared by Divij Kumar, a 5<sup>th</sup> year law student at the Army Institute of Law, Mohali who is pursuing his internship at PSA).*

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<sup>8</sup> Section 58 of the Customs Act, 1962