## Chapter V: Tax administration

SEZs in India had availed tax concessions to the tune of ₹ 83,104.76 crore (IT- ₹ 55,158; Indirect taxes-₹ 27,946.76 crore) between 2006-07 and 2012-13. Our review of the tax assessments indicated several instances of extending in-eligible exemptions/deductions to the tune of ₹ 1,150.06 crore (Income tax ₹ 4.39; Indirect Taxes ₹ 1,145.67 crore) and systemic weaknesses in Indirect and Direct tax administration to the tune of ₹ 27,130.98 crore.

The withdrawal of exemption from MAT/DDT was considered by business as an important measure affecting the promotion of SEZs in the country

SEZs avail various concessions/exemptions of Central as well as State taxes. Annual Statement of Revenue forgone under Central Tax System presented along with the Union budget by the Ministry of Finance quantifies the tax expenditure/ revenue forgone under various schemes. The tax expenditure on SEZs for the period from 2006 to 2013 works out to ₹ 83104.76 crore on account of Direct Taxes and Customs. However, this Statement of Revenue Forgone does not include revenue forgone on account of Central Excise and Service Tax in relation to SEZs. Further, concessions under State statutes viz., Stamp Duty, VAT, CST, etc could not be quantified in the absence of any monitoring mechanism. Therefore, these estimates do not give a true picture of the revenue forgone. However, the Ministry of Finance, in a study, pegged the loss at ₹ 1,75,487 crore from tax holidays granted to SEZs between 2004 and 2010. The revenue forgone by CBEC and CBDT during the year FY 08 to FY12 was tabulated below:

Amount ₹ in crore

| | Scheme | FY08 | FY09 | FY10 | FY11 | FY12 |
|---|---|---|---|---|---|---|
| Customs | SEZ | 1803.95 | 2324.29 | 3987.06 | 8630.16 | 4559.87 |
| | DEPB (SEZ) | 29.29 | 4.52 | 19.51 | 20.15 | 4.52 |
| | Dbk (SEZ) | 14.84 | 4.45 | 12.28 | 17.85 | 2.55 |
| | Total SEZ | 1848.04 | 2333.41 | 4080.85 | 8668.16 | 4566.94 |
| | Other Schemes | 66331.15 | 58839.82 | 48587.54 | 62360.32 | 64111.45 |
| | On Commodities | 85414 | 164579 | 181344 | 159103 | 202015 |
| Direct Taxes | SEZ | 3000 | 3313 | 5515 | 6637 | 12667 |

Under this section we have discussed category of tax wise deficiencies noted in the manner in which these concession were allowed to SEZ Developers/Units.

***Direct Taxes***

### 5.1 No time limit for realisation of exports proceeds

The intent of enactment of sections 10A/10B/10BA/10AA in the Income Tax Act, 1961 is to encourage exports which in turn would infuse the economy with foreign currency remittances.

Timely 'foreign currency remittances' into India is the underlying intent spelt out in section 10A, section 10B and section 10BA. However, no such provision was made in section 10AA, thereby the objective of timely remittance of 'foreign currency' into India gets defeated.

Further, the RBI vide its circular No. 91 dated 01 April 2003 and master circular 09/2009-10 dated 01 July 2009 decided to remove the stipulation of twelve months or extended period thereof for realization of export proceeds from SEZs. Accordingly, there was no provision for any time limit for realization of exports made by Units in SEZ. Further, in the case of Units who are into the business of Gems and Jewellery, they are allowed to receive the export payments in the form of precious metals (Gold/Silver/Platinum) equivalent to value of jewellery exported on the condition that the sale contract provides for the same and the approximate value of the precious metal is indicated in the relevant Forms.

With due regard to the slump in the economy and attendant constraints the entities face, lack of a provision to monitor the economic output of the units at specified periodical intervals (although it may be acting as an incentive) is not in line with the spirit of the Scheme.

We observed in a few illustrative cases viz., M/s Suzlon Wind International Limited, CIT-III, Bangalore, Karnataka and M/s S.E. Blades Limited, CIT-III, Bangalore, Karnataka for AYs 2009-10 that the export proceeds amounting to ₹ 1,579.50 crore and₹ 347.71 crore respectively were not received to the end of 31 March 2009. Similarly, in the case of M/s Tata Consultancy Limited, a Co-developer-cum-Unit (IDCO SEZ), Odisha for the year AY 2011-12 revealed that export proceeds of ₹ 10.44 crore for the period January 2009 to March 2012 was outstanding for more than 3 years.

DoR in their reply (25 April 2014), while accepting the discrepancy in section 10A/10B etc and section 10 AA, stated that the section 10 AA was inserted in the Income Tax Act through the SEZ Act 2005 by MOC&I and the realisation of forex in twelve month was earlier mandated by RBI but this condition was removed by RBI in 2009; however, the reason for the removal of this condition was not elucidated by DoR.

Further, in their reply stated (June 2014) that RBI has issued instruction in June 2013 to realize the proceeds within twelve months.

Reply is not acceptable to audit because as per RBI circular dated 11/06/2013, the time limit for repatriation of foreign exchange by SEZ Units is twelve months. This circular is issued for regulation of foreign exchange as per Foreign Exchange Management Act 1999 read with Foreign Exchange

Management (Export of Goods and Services) Regulations 2000, and which has no relevance to the Income-Tax Act 1961. Therefore, there is no specific provision in the Income-Tax Act 1961 for timely remittance of export proceeds for claiming deduction u/s 10AA.

### 5.2 Absence of clarity in the Income Tax Act, 1961

The following issues in the Income Tax Act, 1961 require clarity.

Section 10A/10AA/10B/10BA of the Income Tax does not define the terms '*profits of the business*', '*total turnover of the business',* thereby assessees get an opportunity to tweak their 'profits of the business' and 'total turnover of the business' according to their suitability which facilitates incorrect claim of deductions.

Assessees compute 'Profits of the businesses' either under normal provisions or adjusted book profits u/s 115 JB, whichever is beneficial to them. Similarly, although the expenses like freight, telecommunication charges or insurance, and foreign exchange expenses for rendering services outside India shall be excluded from 'Export turnover', the same expenses were also being excluded from the 'Total turnover of the business'.

DoR in their reply (April 2014) stated that the deduction under 10A/10B of the Income Tax Act is with reference to the profits and gains derived from the export of articles or things. Under section 10AA, the deduction is also available on profits and gains derived from the services. Sub-section (7) of section 10 AA provides that the profits and gains derived from the export of articles or things or services shall be the amounts which bears to the profits of the business of the unit, the same proportion as the turnover in respect of such articles or things or services bears to the total turnover of the business carried on by the unit.

The 'profit of the business' for the purposes of deduction under section 10AA has to be computed in accordance with the provisions of part D of Chapter IV of Income Tax Act dealing with the head 'profits and gains of business or profession'. For the purposes of deduction under section 10AA, the term 'export turnover' has been given a specific meaning. The other terms such as 'total turnover' in the absence of a definition in the Act will have dictionary meaning. Therefore, the profit of the business for the purposes of deduction under section 10AA has to be computed in accordance of chapter IV D and such profits are not the book profits on which MAT liability is determined.

Audit is of the opinion that though sub-section (7) of section 10AA(7) defines the amount of deduction to be calculated in proportion to the ratio between export turnover and total turnover and profits of the business or profession of the undertaking to be calculated as per part D of Chapter-IV, however, what should 'profits of the business or profession' of the undertaking constitute for the purposes of deduction u/s 10AA is not defined clearly, whether 'other incomes' and incomes which are not having nexus with exports shall also qualify for deduction under section 10AA. Similarly, 'total turnover of the undertaking' is also not defined.

DoC in their reply (June 2014) stated that already MAT and DDT have been imposed. Other reduction of tax benefits will make the SEZ units unviable.

CBDT in their reply (June 2014) stated that the term 'profits of the business' as referred in section 10AA(7) implies profits as computed in accordance with the provisions of the Part D of Chapter-IV of the Income-tax Act. It was also replied that it is not open to Unit to interpret the expression 'profits of the business' to mean book profits as mentioned in the observations of the Audit.

Export Turnover shall have the meaning assigned to it in Explanation 1 of section 10AA. However, in the absence of any definition, 'total turnover' shall have its dictionary meaning.

Reply is not acceptable to audit because sub-section (7) of section 10AA defines the amount of deduction to be calculated in proportion to the ratio between export turnover and total turnover. Such profits of the business or profession to be calculated as Part D of Chapter-IV.

However, it did not define clearly what should 'profits of the business or profession' of the undertaking constitute for the purposes of deduction u/s 10AA, whether 'other incomes' or 'incomes' which are not having nexus with exports shall also qualify for deduction.

Adoption of dictionary meaning for the term 'total turnover of the undertaking' (not defined in the Act) is a clear loophole in the Act, and encourages assessees' to quantify deduction more beneficially. However, the exact reason for not defining the terms 'profits of the undertaking' and 'total turnover of the undertaking' was not elucidated in its reply.

### 5.3 Need for review of taxing mechanism in view of re-introduction of DDT

Any amount declared, distributed or paid on or after 01 June 2011 by domestic companies within SEZ by way of dividend attracts dividend distribution tax (DDT) vide proviso below sub-section (6) of section 115-O of Income Tax Act 1961. Further, provisions relative to payment of MAT were reintroduced for units operation within SEZs AY 2012-13. When SEZ Act was promulgated, sub-section 6 of 115JB and sub-section 6 of 115O was introduced in the IT Act totally exempting the developers/units within SEZs from payment of MAT and DDT. However, re-introducing these taxes during AY 2012-13 and 01 June 2011 for a scheme aimed at incentivizing exports from these Zones, dampens its relative attractiveness vis-à-vis DTA operations. Further, it signals an unstable fiscal regime to the investors in these Zones, further impacting forex inflow and thus being counterproductive in the long run.

DoR in the Exit meeting stated (29 April 2014) that MAT/DDT are nothing but advance tax to be adjusted in subsequent year, in other words it only affects the cash flow of the developer/unit. This was introduced to avoid cases where the developer/units took the Income Tax benefit and opted out of the scheme after some time.

DGEP further added that new IT/ITES units were operating in SEZs and due to imposition of MAT/DDT, the input price of goods manufactured in SEZs increased in comparison to goods manufactured in non-SEZ units.

DoC in their reply (June 2014) stated that DoC has requested Ministry of Finance to withdraw DDT, but the same has not been agreed so far.

CBDT in their reply (June 2014) stated that MAT is based on the principle that every person participating in the economy must contribute to the exchequer. It also quoted the Supreme Court judgement in Lakshmi Devi's case wherein the Hon'ble court held that all decisions in the "economic and social spheres are essentially adhoc and experimental. Since the economic matters are extremely complicated, this inevitably entails special treatment for special situations. The State must, therefore, be left with wide latitude in devising ways and means of fiscal or regulatory measures, and the courts should not unless compelled by the statute or by the Constitution, encroach into this field or invalidate such law."

Audit appreciates the point regarding contribution to the exchequer and also that the state has full powers of dealing with economic matters. However, the audit point is raised vis-à-vis the impact that reintroduction of MAT & DDT has had on the overall economic sentiment vis a vis the SEZ scheme. Audit point is also echoed by the stakeholders of the SEZ viz., the Developers and Units, details of which are outlined in paragraph 6.4.

### 5.4 Failure to invoke provisions of Wealth Tax

As per section 2(ea) of Wealth Tax Act 1957 - asset, *inter alia*, includes any unused land held by the assessee for industrial purposes for a period of 2 years or as stock-in-trade for a period of 10 years from date of its acquisition is not treated as asset. We noted that SEZ developers were in possession of large tracts of land, and in certain cases the chunk of land is kept idle for a longer duration than the period permissible under the provisions of section 2(ea). It was observed that, selection of assessment for scrutiny basically covers assessees who are actively conducting business operations. However, lands which are not allotted to any Units for various reasons are not monitored for the purposes of invoking the provisions of Wealth Tax Act. The details of such cases are illustrated below:

| Name of the State | No. of SEZs involved | Area notified (Hectares) | Earliest date of Notification |
|---|---|---|---|
| Andhra Pradesh | 22 | 1408.13 | 12/2006 |
| Gujarat | 13 | 925.92 | 09/2007 |
| Karnataka | 6 | 378.334 | 08/2006 |
| Maharastra | 88 | 8987.90 | 04/2007 |
| Rajasthan | 2 | 61.943 | 09/2003 |
| Tamilnadu | 23 | 1239.861 | 04/2007 |
| West Bengal | 13 | 953.629 | 08/2007 |
| Total | 167 | 13955.717 | |

DoC in their reply stated (June 2014) that land in SEZs is to be viewed in a special context as its use is dependent upon the units coming into SEZ, and the entry and exit of the units in SEZ is dependent on factors such as market conditions, the Govt. policies etc. The observation of Audit may not be relevant, if BoA after considering the proposal extends formal approval depending upon merits of each case.

However, CBDT in their reply (June 2014) stated that the matter is under consideration of CBDT. Necessary instructions have been issued to the field authorities to determine the unused land lying in each SEZ vis-a-vis the time period for which the same is lying idle. Field officers have been directed to closely monitor and wherever required invoke provisions of wealth Tax Act of urban land falling in SEZs that escapes the exemptions provided in definition of urban land as contained in para (b) of the explanation 1 contained in Section 2 (ea) of the Wealth Tax Act 1957.

DoC may intimate the final outcome to audit.

### 5.5 Changes in the Direct tax incentives

In the investment linked regime, specified businesses will experience accelerated depreciation which in other words means the new regime would favour capital intensive industries. In a scenario where multi-product SEZs constitutes only 4 per cent of the total sectors, this move would trigger establishment of more capital intensive (multi-product) industries. This would facilitate more employment to unskilled people. However, the other side of this change would impact the sectors where 'employed intensive industries' including IT sectors which is not capital intensive and lesser requirement of capital. This may be in direct contradiction with the SEZ's objective of generating employment.

Further, with MAT and DDT being reintroduced, the tax paid by DTA units is less than the tax paid by SEZ units as illustrated below:

The tax payable by the company, if its operations are carried out in a domestic tariff area and in a SEZ would be as under:

| | DTA | SEZ | |
|---|---|---|---|
| AY 2012-13 | **32.445 per cent**<br>{30% + 5% (SC) + 35 (SHEC)} | MAT<br>20.008 per cent<br>(18.5% + 5% SC + 3% S.H.E.C) | DDT<br>16.995 per cent<br>15% + 10% + 3% S.H.E.C |
| | | **Effective Tax : 37.003 per cent** | |

The above scenario may partially answer the question regarding reasons for many units seeking extensions, resizing, and de-notification of the proposed projects. Though it may not fully typify the scenario as there could be other valid reasons, the following chart shows an increase in the number of de-notifications after re-introduction of MAT and DDT:

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| Partial de-notification | 1 | 3 | 5 | 7 | 5 |
| Full de-notification | 4 | 7 | 10 | 6 | 4 |

This sentiment was also echoed in the responses given by the developers/units in response to a question of survey questionnaire for developers/units on the reason for their exit from the scheme.

**Comparison of duty structure and taxes in SEZ and DTA in engineering industry**

| **Comparison of duty structure and taxes in SEZ and DTA** | |
|---|---|
| **Engineering industry SEZ** | **Engineering industry DTA** |
| Nil custom duty on capital | Customs duty 7.5 % on capital goods( zero if unit exports 6 times duty forgone) |
| Nil CVD on capital goods | CVD 12% on capital goods+ 3% cess+ 3% edu cess + 4% addl duty (zero if unit exports 6 times duty forgone)<br>Note- CVD+ cess + edu cess+ SAD are eligible for cenvat credit |
| CST - NIL | CST - 2% |
| CST - 2% | VAT 14.5% (excavators) - this can be adjusted against VAT on inputs |
| Excise duty -Nil | Excise duty payable at 12% (now 10% till June 2014) |
| Service tax - Nil for services rendered or received | Service tax 10.5% payable for services rendered or received |
| No income tax for first 5 yrs (MAT 18.5% payable) | Income tax payable from first year |
| 50% income tax for 2nd 5 years ie 16.5% but mat applicable at 18.5% | Income tax payable in all years |

| | |
|---|---|
| 50 % income tax in 3rd 5 yrs ie 16.5% but mat applicable at 18.5% | Income tax payable in all years |
| No duty on raw material imports (duty+CVD+SAD) | Duty payable but advance license for imports can be taken with 20 % value addition |
| Sales to DTA with duty+CVD+SAD subject to +NFE | Exports to SEZ get duty drawback |
| No chapter 3 benefits | Chapter 3 benefits applicable |
| Duty drawback on exports - Nil | Drawback allowed as per product category |
| Eg- if a company in SEZ exports for ₹ 100 - net realisation is 100. If profit is 10% then tax savings is (33%*-18.5%= 14.5%) of ₹ 10= ₹ 1.45, therefore effective realisation = ₹ 100 + ₹ 1.45 = ₹ 101.45<br>In case of DTA unit, exports for ₹ 100 with 50% import content for which custom duty is 7.5 %= ₹ 3.75. The unit also gets drawback 4 %= ₹ 4 and Chapter 3of FTP benefit of ₹ 4. Further the unit pays additional tax compared to SEZ unit =14.5% =₹ 1.45 (as the unit is not saving any tax as in the case of SEZ unit above) . Therefore, the effective realisation is ₹ (100-3.75+4+4-1.45) =₹ 102.80. Hence working in DTA is beneficial.<br>* 30% (tax) + 10% (SC) | |

DoC in their reply (June 2014) while accepting that the introduction of MAT and DDT has affected the SEZ scheme adversely and there has been an increase in the number of de-notifications after introduction of MAT and DDT on SEZs stated that the decision to de-notify a SEZ may depend on a host of factors like global recession, industry specific reasons, local factors etc.

**Recommendation:** *DoR may like to visit the Income Tax Act, 1961 and Wealth Tax 1957 in view of the:*

I. *Need for timely remittance of foreign currency remittances which was not provided for under section 10AA as in the case of Sections 10A, 10B, and Section 10BA;*

II. *Section 10A/10AA/10B/10BA of the Income Tax which does not define the terms 'profits of the business', 'total turnover of the business', thereby assessees get an opportunity to tweak their 'profits of the business' and 'total turnover of the business' according to their suitability which is resulting in incorrect claim of exemptions;*

III. *Misuse of Section 2(ea) of Wealth Tax Act 1957 where asset, inter alia, includes Land held by the assessee as stock-in-trade for a period of 10 years from date of acquisition; and*

IV. *Impact of levy of DDT and MAT in SEZs vis-a-vis DTA units based on an empirical study.*

***Direct Tax: Compliance issues***

Income Tax Act provides deductions to the assessees operation in the SEZs subject to certain conditions. Compliance issues related to non-adherence of such conditions involved deficiencies in Tax administration to the tune of ₹ 12.08 crore as detailed below:

**Information Technology Sector**

### 5.6 Excess claim of deduction

In the case law, DCIT Baroda vs. Rameshbhai C. Prajapati ITAT Ahmedabad C Bench it was held that disallowance of expenditure u/s 40(a)(ia) shall not qualify for any deduction. Further, disallowance of employees contribution to provident fund/superannuation fund etc., u/s 36(1)(va) is to be computed under the head income from other sources[15] which shall not qualify for any deduction.

In the case of M/s Xavient Software Solutions (India) Pvt. Ltd, CIT Noida - Uttar Pradesh AY 2009-10, it was seen that deduction u/s 10AA to the tune of ₹ 27,62,799 was allowed without Auditor's Report in Form 56F which is mandatory u/s 10AA(8) read with section 10A(5) and hence deduction need to be disallowed. The short demand worked out to ₹ 8,56,072.

### 5.7 Incorrect computation of loss

As per section 80A(2) the aggregate amount of deduction shall not, in any case, exceed the gross total income of the assessee.

In the case of M/s Ernst & Young Pvt. Ltd., CIT-III Kolkata, West Bengal for AY 2010-2011 deduction was allowed u/s 10A and 10AA at ₹ 63,76,99,495 against total taxable income of ₹ 55,86,57,869 which resulted in incorrect determination of loss of₹ 7,90,41,626. The potential tax effect worked out to ₹ 1,68,46,696.

**Pharmaceutical Sector**

### 5.8 Excess claim of deduction

In the case of M/s Biocon Research Ltd., CIT-I Bangalore, Karnataka for AY 2010-11 we noted that a non-refundable amount of ₹ 38,44,00,000 was received from M/s Mylan Gmbh, Switzerland for undertaking research and development activities on which deduction u/s 10AA was claimed to the tune of ₹ 15,46,72,345 without Auditor's Report in Form 56F which is mandatory u/s 10AA(8) read with section 10A(5). However, Assessing Officer estimated income at ₹ 7,68,80,000 (20 per cent of agreement amount of ₹ 38,44,00,000) and allowed deduction to that extent u/s 10AA.

[15] *section 2(24)(x) read with section 56(2)(ic)*

We noted that, the amount of ₹ 38,44,00,000 received by the assessee was not on account of export of any articles or things or provide any services but for the purpose of 'initial execution for M/s Mylan and Biocon Collaboration' and, therefore, would not qualify for deduction. Hence, incorrect allowance of deduction of ₹ 7,68,80,000 need to be brought to tax. The tax effect worked out to ₹ 2.61 crore. It was replied (January 2104) that the issue would be examined.

**Foliage and Handicrafts Sector**

### 5.9 Failure to examine inter-unit transfer of stocks and Non-restriction of deduction to computed profits

In the case of M/s Vaachi International Pvt. Ltd., CIT-III Kolkata, West Bengal for AYs 2010-2011 and 2011-2012, inter-unit stock transfer from non-SEZ Unit to SEZ Unit of ₹ 1,76,29,081 and ₹ 2,42,05,506 respectively was not examined [sub-section (9) of section 10AA read with sub-section (8) of section 80IA] while completing regular assessmentu/s 143(3). Further, deduction of ₹ 84,73,452 was not restricted to the amount of profit available of ₹ 80,67,795 which resulted in incorrect determination of loss of ₹ 4,05,657 with a consequential potential tax effect of ₹ 1,25,348.

**Other**

### 5.10 Non-submission of Auditor's Report

As per section 10AA(8) read with section 10A(5) deduction shall not be admissible unless the assessee furnishes the Auditor's Report in Form 56F.

In the case of M/s Parampara Builders (P) Limited, CIT Moradabad, Uttar Pradesh for AY 2010-11 that, the assessee company claimed deduction u/s 10AA to the tune of ₹ 34925 without Auditor's Report in Form 56F.

***Indirect Taxes***

SEZ Act provides exemption of duties of customs, central excise and service tax for operations within SEZs subject to certain conditions. Compliance issues related to non adherence of such conditions that involve deficiency tax administration to the tune of ₹ 28,268.96 crore are discussed below.

### 5.11 Absence of mechanism for accounting of Service tax exemption

Rule 12(1) of SEZ Rules stipulates that the Developer may import or procure goods and services from the DTA, without payment of duty, taxes and cess for the authorized operations, subject to the provisions contained in Sub-rule (2) to (8). Duty free procurement of services was inserted from June 2010.

Sub rule 5 states that the Developer shall execute a Bond-Cum-Legal Undertaking (BLUT) in Form-D, jointly with the Development Commissioner and Specified Officer, with regard to proper accounting and utilization of goods for authorised operations within a period of one year or such period, as may be extended by the specified officer.

We observed that even though duty free services were being allowed to Developers, there was no mechanism in place to capture the duty forgone on account of Service Tax availed by the Developers. Monitoring is done without this vital information even though the eligibility for availing exemption viz., list of authorised services and Form A-1 is given by DC/specified officer only. Consequently, Service Tax exemptions availed by the Developers cannot be considered while calculating the total indirect tax exemptions availed by the Developers. Further, duty free procurement of services by the developer was inserted under Rule 12 wherein requirement of Bond cum Legal Undertaking (BLUT) was also stipulated. Hence, duty free service components should also factor in while quantifying the value of BLUT to monitor the total duty forgone.

In this milieu, our analysis of ST exemption availed by the Developers obtained through concerned DCs indicated that 46 Developers/Co-developers in Andhra Pradesh, Gujarat, Maharashtra, Tamilnadu, Kerala and Odisha had availed ST exemption to the tune of ₹ 1,559.43 crore as on March 2013, but the same could not be verified, monitored and accounted for by the DC while calculating the Indirect Tax Benefits extended as there was no mechanism in place to facilitate this. The interest of Government would have been protected even if the exemption was quantified and covered by Bond-cum-Legal Undertaking (BLUT).

We believe that this is a serious risk which facilitates revenue leakage which unfortunately was not being monitored either at the level of DC or the jurisdictional Commissionerates. This loophole assumes significance as de-notification request of Developer is approved by BoA based on the recommendations of DCs wherein the details of recovery of total exemptions availed by the developer is given. In the absence of a mechanism for accounting of Service Tax exemptions, the computation of the total dues to be recovered by the DC is flawed, facilitating undue benefit to the Developers. Two such cases are highlighted in Box-11.

**Box-11: De-notification allowed without recovering Service Tax due**

BoA approved de-notification relying on the certificate furnished by the DC without taking cognizance of Service Tax Exemption of ₹ 33.01 lakh availed by two Developers/units in Tamilnadu (M/s Aspocomp Electronics and Estra IT Park).

BoA in their meeting held in August 2009, approved de-notification in M/s Maytas, Gundlapochampally, Andhra Pradesh subject to payment of ST exemption of ₹ 31.46 lakh which was not paid till date (August 2013).

**Box-11 (Contd..): De-notification allowed without recovering Service Tax due**

The cited instances occurred as the Department did not have a system of monitoring and accounting the exemption allowed on account of Service Tax.

DoC in their reply (June 2014) stated that this aspect has already been taken care of and as per notification dated 01 July 2013 issued by DoR, the mechanism for monitoring of availment of Service Tax has been incorporated and developers/units are required to submit quarterly report to the jurisdictional ST Authority.

The conditions of the BLUT in para 2 provides for refund of service tax exemption availed by the developer.

Reply is not acceptable as all the duty free benefits availed by the Developers were being monitored by Specified Officers (Customs) through BLUT and hence the value of duty free service availed by the Developers should also be monitored through BLUT. Further, the issue raised in the audit observation was availment of ST exemption by Developers/units and accounting thereof by DC for calculating the Indirect Tax benefits availed by Developers/units and covered under BLUT. DoC's reply is silent about the mechanism that they have with ST Commissionerates to safeguard the revenue in such cases.

***Recommendation:*** *MOC&I may review the arrangements in place for Service Tax administration as there was no mechanism for capturing, accounting, and monitoring of ST forgone by DC or the jurisdictional ST Commissionerates.*

### 5.12 Incorrect exemption of service tax

Export of Services Rules, 2005 introduced exemption of service tax on export of taxable services subject to two conditions i.e such service is provided from India and used outside India and the payment for such service provided outside India is received by the service provider in convertible foreign exchange.

In Andhra Pradesh, M/s Satyam BPO Ltd., an SEZ Unit in Satyam Computer Services Ltd. IT/ITES SEZ, Madhapur, Hyderabad were engaged in providing information technology software services (ITSS) and other related services to various clients in India as well as abroad which also included services provided to its parent company M/s Tech Mahindra and M/s Satyam Computers Ltd. The assessee paid Service Tax on services rendered in DTA and claimed exemption for other services under Export of Service Rules 2005. However, we noted from the scrutiny of the services claimed to have been exported that a few services were rendered to its parent companies which were billed to the locations in India and the money received was in Indian currency which is in contravention to the rules stated supra.

As per the Annual Performance Report for the year 2011-12, the Unit has done deemed exports worth ₹ 43.81 crore to its parent companies and claimed exemption under Export of Service Rules 2005 which was incorrect and hence Service Tax is leviable @ 10.3 per cent which works out to ₹ 4.51 crore which needs to be recovered along with interest.

We also noted that the assessee was paying Service tax on similar transactions (Deemed Exports) from July 2012 onwards, which corroborates the audit observation. However, the assessee had not paid any Service Tax for the prior period in question.

Similarly, in Karnataka, in the case of M/s Syngene International Ltd.(Unit I to VI) in Biocon SEZ, services amounting to ₹ 47.94 crore claimed to be exported were actually rendered to its group companies billed in India and money was also received in Indian currency. Service tax liability of ₹ 5.13 crore on the services rendered needs to be recovered along with Interest.

DoC in their reply (June 2014) stated that Satyam Services rendered services within SEZ and whole amount realized in FE. The only issue was to verify whether double IT exemption was taken. Even though M/s. Satyam BPO did not receive foreign currency directly for the services rendered by them to overseas clients, the transaction should be treated as export of service by M/s. Satyam BPO. The money for the services rendered by M/s. Satyam BPO was received in foreign currency by M/s. Satyam, who in turn paid them in Indian currency. Commissioner (Appeals) and CESTAT have upheld this contention and as it stand now, such transactions have to be treated as export of services. They have started paying Service Tax after the enactment of the “Place of Provision of Services Rules, 2012”.

CESTAT vide order No. 1382 to 1386/2008 dated 4.11.2008, allowed the Unit to obtain refund for the Service Tax paid on the services provided to the client located abroad.

Reply is not tenable as the basic condition of receiving proceeds in foreign currency for treating a service to be exported is not satisfied by M/s Satyam BPO. The unit was rendering service to its parent company (Satyam and Tech Mahindra) in India and classifying it in the APRs as deemed exports which is not envisaged in the Export of Service Rules 2005 and hence the benefit of exemption cannot be granted. Further, possibility of double claim under export of service by both Satyam BPO and its parent company cannot be ruled out.

### 5.13 Failure to pay Service Tax under Reverse charge Mechanism

Rule 2(1) (d)(iv) of Service Tax Rules, 1994 specifies that the service receiver as the Person liable for paying service tax in relation to any taxable service provided or to be provided by any person from a country other than India and received by any person in India under section 66A of Finance Act 1994. Benefit of exemption of Service Tax under section 66A for SEZ Units has been introduced from March 2011 and no such exemption was in effect for the prior period.

We noted 33 instances of incorrect availment, *ab-initio,* of exemption of Service tax in Andhra Pradesh, Karnataka, Madhya Pradesh and Tamilnadu amounting to ₹ 287.52 crore under 66A for the period prior to March 2011 which need to be recovered along with interest**.**

Further, for the subsequent period the units were required to get approval of the services as specified services for availing *ab-initio* exemption of service tax liability under reverse charge mechanism u/s 66A.

We noted in 23 cases involving incorrect exemption of ₹ 128.28 crore in Andhra Pradesh, Tamilnadu, Karnataka and Rajasthan, which did not comply with the conditions stipulated for claiming *ab-initio* exemptions which needs to be recovered along with interest**.**

DoC in their reply (June 2014) stated that audit tried to point out that Service Tax exemption was not available for services availed by SEZ units from abroad for the period March, 2009 to February, 2011. Services provided by Indian suppliers is covered under section 66 of Service Tax Act and services provided by supplier from abroad are covered under section 66(A) of Service Tax Act.

By virtue of notification dated 03.03.2009, the Government introduced exemption from Service Tax for the services used by SEZ Unit / Developer by way of refund which hitherto was unconditionally exempted. In other words, before 03.03.2009, Service Providers were not required to pay Service Tax for the services rendered by them to a SEZ Unit / Developer. The above modus operandi of granting exemption by way of refund was limited to Service Tax paid under Section 66 of the Finance Act. Thus, Service Tax payable under Reverse Charge Mechanism in terms of Section 66A of Finance Act, 1994 continues to be unconditionally exempted.

Notification dated 20.05.2009 was issued amending the notification dated 03.03.2009 to exclude exemption by way of refund in respect of such services which are wholly consumed within SEZ. Thus, in respect of services which are consumed within SEZ again become unconditionally exempted.

In view of the above statutory provisions, the issue raised by audit that RIL SEZ Unit was liable for Service Tax in respect of Service Providers located outside India in terms of Section 66A for the period from March, 2009 to February, 2011 is not legally tenable.

The reply is not acceptable to audit as SEZs are deemed to be foreign territory under SEZ Act, but not under Finance Act 1994 and hence liable for levy of service tax unless specifically exempted. Benefit of exemption of service tax under 66A was allowed from March 2011 vide notification No.17/2011 and hence, exemption benefit is to be allowed for the subsequent period provided the conditions stipulated in the notification was adhered to. Further, benefit of exemption is given at DC level by issuing Form A1 and also declaring the nature of specified services. Hence, in our opinion the action for non-compliance needs to be initiated by DC only.

### 5.14 Non-payment of Service Tax

In terms of notification dated 3 March 2009, taxable services specified in Clause (105) of Section 65 of the Finance Act, 1994, chargeable to service tax under Section 66 of the said Act, received by a Unit located in a Special Economic Zone or Developer of SEZ for authorized operation, are exempt from the whole of service tax, education cess and secondary and higher education cess leviable thereon. It therefore follows that such an exemption is not available if the Developer/unit is engaged in operations not connected with the Zone.

In terms of Section 65(30a) of the Finance Act, 1994, construction of residential buildings, townships, row-house complex, etc. would attract service tax with effect from 16 June 2005. We noted in the following two instances Service Tax due from the concerned units was not recovered.

(a) M/s. New Chennai Township Private Limited, Cheyyur, a SEZ developer**,** owners of land measuring 612 acres, had obtained approval from the BoA (January 2008) for promoting two SEZs viz. Light Engineering Sector (312 acres) and Multi-Sector service (300 acres). Further scrutiny revealed that though nine units who had obtained approval for manufacturing and service activities in the said Zones commenced operations only during 2011-12, the Developer had started constructing residential apartments in each Sector in the Non-Processing Area and received advances from prospective customers, as early as in 2007-08 onwards. In the two phases of construction completed, 580 residential apartments were leased out to individuals unconnected with the authorised operations of the Zone.

Despite carrying out activities not connected with the authorised operations of the Zone, the Developer did not discharge the service tax obligation to the tune of ₹ 16.42 crore, computed on the total income from operations amounting to ₹ 150.76 crore received from the prospective buyers during the period from 2007-08 to 2012-13 towards construction of these residential buildings.

(b) Taxable services of transportation of goods by vessel are liable to Service Tax with effect from 1 September 2009 subject to exemption granted to transportation of specified goods listed out in the Table annexed to the Notification No.25/2012 – ST dated 20 June 2012. Further, Notification No.26/2012-ST dated 20 June 2012 permitted abatement of 50 *per cent* of the gross amount charged for determining the value of taxable service of transport of goods in a vessel from one part to another part in India.

M/s. Larsen and Toubro Limited, Modular Fabrication Facility, Kattupalli, an SEZ unit in Tamilnadu had transported their finished product viz., “Process-cum-living quarters platform” meant for Deendayal Field Development Project of M/s. Gujarat State Petroleum Corporation Limited, Kakinada Coast, Andhra Pradesh by Barge-Posh Giant-I with Tug-Martime Mesra during 2012-13 for a value of ₹ 184.27 crore and incurred transportation charges of ₹ 37.27 crore. Inasmuch as the goods were not covered in the Notification first cited *supra*, the unit is liable to pay Service Tax amounting to ₹ 2.30 crore (@12.36 per cent of 50 per cent of ₹ 37.27 crore**)**, calculated on the abated value of the goods, which is recoverable along with applicable interest.

(c) In term of sub-rule 3 of rule 27of SEZ Rules, Import of duty-free material shall not be permitted for operational and maintenance activity in the non-processing area. It, therefore, follows that exemption from duties/taxes is not admissible for such activity.

Further, as per clause (90a) of section 65 of the Finance Act, 1994 “renting of immovable property” includes renting, letting, leasing, licensing or other similar arrangement of immovable property for use in the course of furtherance of business or commerce. Explanation 2, thereunder, provides “renting of immovable property” also includes allowing or permitting the use of space in an immovable property, irrespective of the transfer of possession or control of the said immovable property. The activity of renting of immovable properties for commercial use is liable to Service Tax with effect from 1 June 2007 under the service of “Renting of Immovable Property”.

M/s. L&T Shipbuilding Limited, Kattupalli, awarded 'Operation and Maintenance of the container port terminal' at Kattupalli Village, to a Contractor viz. M/s International Container Terminal Service (India) Private Limited on receipt of Contract Licence Fee of ₹. 85.45 crore during the year 2011-12. However, the unit did not discharge its service tax liability amounting to ₹ 10.20 crore despite the fact that receipt of operation and maintenance charges was not exempt from Service tax in terms of rules cited above.

DoC in their reply (June 2014) stated that in case of specific demand, SCN will be issued for recovery of the Service Tax wrongly availed. Further, in the case of M/s New Chennai Township Pvt Ltd, Cheyyur, during the period 2007-08 to 2012-13 amounting to ₹ 16.42 crore, action has been initiated against the Developer and the case of M/s L&T Shipbuilding Ltd. regarding payment of Service Tax amounting to ₹ 2.30 crore along with interest is being referred to Service Tax Department.

DoC may intimate the final outcome to audit.

### 5.15 Insufficient Bond - Cum Legal Undertaking

Rule 22 of SEZ Rules, 2006, stipulates that the value of the Bond Cum Legal Undertaking (BLUT) shall be equal to the amount of effective duties leviable on import or procurement from the Domestic tariff Area (DTA) of the projected requirement of capital goods, raw materials, etc for three months as applicable. Where the value of BLUT executed falls short on account of requirement of additional goods, the unit or the Developer shall submit additional BLUT.

We noted in 13 cases in Andhra Pradesh, Karnataka, Maharashtra and Uttar Pradesh where the value of BLUTs executed had fallen short by ₹ 1037.71 crore and additional BLUT was not submitted. A case of executing BLUT 8 years after notification noted in Jaipur is highlighted in Box-12.

**Box-12: Execution of BLUT eight years after notification**

In Rajasthan the developer (RIICO) had not entered BLUT for eight years in respect of two SEZs (Jaipur SEZ I and II). The SEZs were notified in July 2003 and February 2004 and the Developer executed the BLUT jointly for ₹ 10 lakh in May 2012 i.e, after 8 years of notification.

DoC in their reply (June 2014) stated that in case of any shortfall in BLUT amount with respect to import/local procurement, the SEZ entities are advised to execute additional BLUT.

DoC may intimate the final outcome to audit.

### 5.16 Physical exports vis-a-vis turnover

The guiding principles of SEZs, *inter alia*, include promotion of exports of Goods and Services. Expressing their concern over fall in physical exports, the Public Accounts Committee (PAC) in its 62nd report in the year 2012-13 emphasised the need for having Physical exports and hence recommended that at least 51 per cent of the production of goods and services by a unit in a SEZ be physically exported out of India.

We noted in 34 cases in Andhra Pradesh, Maharashtra, Karnataka, Tamilnadu, Kerala, Gujarat, Uttar Pradesh and West Bengal that the SEZ units could undertake physical exports ranging from zero to 46.91 per cent only of their turnover thereby defeating the basic objective of the scheme of earning foreign exchange from overseas by the units by resorting to deemed exports/ DTA sales but not effecting actual physical exports to foreign countries. A typical case is highlighted at Box-13 below:

**Box-13: Unit became NFE compliant without physical Export**

M/s Gupta-Zhongchen Electrotech Ltd. in Falta SEZ in West Bengal was allowed de-bonding even though the unit had never cleared any finished goods. The Unit became NFE compliant by clearing all its goods (Raw Materials and Capital goods) to other units in FSEZ itself.

DoC in their reply (June 2014) stated that though the SEZs are primarily viewed as elements of the Government's exports promotion strategy but that is not entirely correct as evident from the above objectives of SEZ scheme.

The unit may sell their goods in DTA against the payment in foreign exchange from the EEFC account or foreign currency received from overseas for calculation of NFE. The goods purchased by the DTA buyer may also be helpful to save foreign currency because, if they could not purchase the same from SEZ, they may have to import the same from overseas which will impact the foreign exchange reserves of the country. Deemed exports refer to import substitution, which has the effect of saving outflow of foreign exchange.

Achieving 51 per cent physical exports is not mandated under the SEZ Act or SEZ Rules. Therefore, the Units cannot be faulted for not achieving 51 per cent physical exports. Imposition of 51 per cent physical exports would affect certain units which have already made investments in the SEZ with the idea of achieving NFE Earnings taking into account their deemed exports also, which is permitted under the present policy for calculation of NFEE under Rule 53 of SEZ Rules.

The reply of the department is not tenable as PAC's 62nd report recommended at least 51 per cent of the production of goods and services by a unit and not for the State put together, need to be physically exported. Further, no foreign exchange, as contemplated in the SEZ scheme, is earned in the case of deemed exports.

### 5.17 Level playing field between SEZs, EOU and DTA units

EOUs get duty free imported/indigenously procured raw materials and subject to certain conditions are even allowed to sell their finished goods into Domestic Tariff Area (DTA) after paying the applicable Basic Customs Duty (BCD) and Countervailing Duty (CVD) as if the final products were imported. However, in cases where both the BCD and the CVD were 'nil', the EOU would not pay any duty on clearance of the final products in DTA. A unit in the DTA producing/clearing same final product would also clear these goods at 'nil' rate of duty, but would have suffered duty on inputs used in the manufacture of these products. This had put the DTA units under a comparative disadvantage. To remove this anomaly, the EOUs were required to pay back the duty forgone on inputs utilised for manufacture of such goods cleared into DTA at 'nil' rate of duty with effect from 1st September 2004.

However, such protection to units in DTA was not provided under the SEZ policy/Act. SEZ units can sell their goods, including by-products, and services in DTA on payment of applicable duty including at 'nil' rate with no requirement to pay back the duty forgone on such inputs used. Proportionate duty forgone on inputs utilized in the manufacture of finished goods cleared at nil rate in DTA works out to ₹ 84.19 crore in 20 SEZ units in Andhra Pradesh, Maharashtra, Gujarat, Uttar Pradesh and West Bengal which could not be recovered in the absence of enabling provisions. Additionally, this policy had put SEZ units at a distinctly advantageous position compared with similar units in the DTA or even other EOUs.

A similar case of inverted duty structure was observed in three Units in Aspen SEZ, Coimbatore, Tamilnadu who were granted LOA in 2007 for manufacture of parts of Wind Mills. The SEZ units were encouraged to clear more into DTA in view of the lesser rate of customs duty on Wind Mill parts which ranged between 5.30 and 7 *per cent* in terms of exemption Notification No. 21/2002 – Cus dated 01 March 2002 whereas the rate of duty payable but for the exemption on the inputs utilized in the manufacture of finished goods ranged between 14 and 21 *per cent*. However, in the absence of enabling provisions, the proportionate duty concession amounting to ₹ 155.00 crore availed by these three units on the raw materials consumed in the manufacture of finished products sold in DTA could not be recovered which would have otherwise discouraged such DTA sales.

DoC in their reply (June 2014) stated that the Units under SEZs operate under the different tax regime compared to EOUs. SEZ units have to pay full duties while clearing the goods into DTA whereas EOUs have concessional duties. The SEZ and EOUs operate under different legal framework and have prescribed entitlements and obligations.

Reply of the department is not acceptable to audit as in the case of final goods cleared in the DTA with nil rate of duties, by SEZ, EOU and DTA units, the EOUs are required to pay back the duty benefits availed while importing the raw material, similarly DTA units also bears the duty liability on the imported inputs, SEZ units while clearing the goods in DTA need not pay any duty benefits availed on the inputs, thus putting both EOU and SEZ in a dis-advantageous position.

***Recommendation:*** *MOC&I may consider recovering duty forgone on inputs utilised for manufacture of finished products, on clearance of such exempted goods in DTA, as is done in the case of EOUs.*

### 5.18 Absence of provisions to consider positive NFE criteria while permitting exit of SEZ unit under EPCG Scheme

EOUs are permitted to exit from the Scheme under the prevailing EPCG scheme under paragraph 6.18(d) of FTP, *subject to achievement of positive NFE criteria.* However, no such restriction is prescribed for SEZs under Rule 74 of SEZ rules which allow units with negative NFE or even non-operational Units to opt for exit.

We noted that M/s. Hazira Plate Ltd., an SEZ unit in Essar SEZ, Gujarat with cumulative Negative NFE of ₹ 285.49 crore (as on 2009-10) had applied for exit of SEZ unit (September 2009) under Rule 74 and intended to clear its capital goods under EPCG scheme. Meanwhile, the unit was issued SCN (February 2010) which was adjudicated by DC, KASEZ wherein the proceedings for negative NFE was dropped and the unit was allowed to exit under EPCG scheme (February 2010) involving duty forgone of ₹ 414.77 crore on total value of plant of ₹ 1,880 crore. Thus, in the absence of restrictive provisions as existed for EOUs scheme, SEZ units are allowed to exit even with negative NFE.

It was further observed in M/s Essar Steel Ltd. in KASEZ, Gujarat that permission to exit under EPCG scheme was allowed (September 2010) to the unit even though the unit could not implement its project, LOP for which was given in 2006.

DoC in their reply (June 2014) stated that EOU scheme is governed by FTP and HBP, whereas SEZs are governed by the provisions of SEZ Act, 2005 and rules framed there under. As per the provisions of Section 51 of the SEZ Act, 2005, the provisions of the Act shall have overriding effect over the provisions of other Acts as such comparing the provisions made out in respect of exit of EOU under FTP and HBP vis-à-vis exit of SEZ units may not be appropriate.

Reply is not acceptable because similar provisions for exit by EOU under EPCG scheme are available subject to achievement of positive NFE by EOU whereas the same provisions are not provided for SEZs.

Audit is of the opinion that Department may consider allowing SEZ units under EPCG scheme to exit only after achieving positive NFE.

### 5.19 Insurance on the amount of duty forgone

As per GOI, MOF, Dept. of Revenue Circular no 99/95 dated 20 September 1995 read with section 65 of the Customs Act 1962, hundred percent EOUs are required to take a comprehensive Insurance Policy, at least for the value equal to customs duty not levied at the time of import.

We noted that in the absence of similar provisions in SEZ Act/Rules, no insurance policy has been obtained in favour of the government, for the amount of duty forgone, putting its interest at risk, although working of SEZ is quite similar to EOUs.

DoC in their reply (June 2014) stated that in terms of provision of Rule 22 of SEZ Rules, 2006, every unit is required to execute a BLUT with regard to its obligations regarding proper utilization and accountal of goods including capital goods, spares, raw material, components and consumables including fuels, imported or procured duty free. The value of the said Bond cum LUT shall be equal to the amount of effective duty leviable on imports or procurements from the DTA of the projected requirement of capital goods, raw materials, spares, consumables, intermediates, components, parts, packing material for their manufacture as applicable and hence there does not appear any need for insuring goods in the name of SEZ authority/customs authority because the BLUT executed by the unit before the Development Commissioner is nothing but surety given by the SEZ unit to pay back the applicable duty for the goods imported or procured from the DTA, goods under authorized operations, goods under movement for export /import, sub-contracting etc. Moreover, taking insurance is a business decision of the Unit.

In audit's opinion the Government's interest is at risk therefore an appropriate provision in the Act for obtaining Insurance policy for the duty forgone in line with EOUs, may be considered.

### 5.20 Failure to meet export obligation

Rule 43 of SEZ Rules 2006 permits subcontracting by SEZ Unit for exports on behalf of the DTA exporter subject to the condition that all the Raw Materials including semi-finished goods and consumables including fuel shall be supplied by the DTA Exporter. Further, finished goods need to be exported directly by the SEZ Unit on behalf of the DTA exporter. However, exports can be made either by the SEZ Unit or EOUs when sub-contracting on behalf of EOUs is undertaken. "Export" as defined in section 2(m) of SEZ Act 2005 means taking Goods/service out of India from a SEZ, supplies from DTA to a SEZ Unit/Developer and supplies from one SEZ Unit to other SEZ unit and does not include Deemed Exports.

In Andhra Pradesh, M/s Hetero Labs (Unit-I) an SEZ unit in APIIC Jedcherla took sub-contracting permission from DC and Specified Officer for manufacture of Zidolam-N amounting to ₹ 149.24 crore. The entire quantum of subcontracted materials was sent to Hetero Unit-III (EOU Unit) and from there, the material was cleared as physical exports as well as deemed exports. Deemed exports of material sub-contracted by the SEZ Unit through an EOU is not in order as the said materials are required to be physically exported under the SEZ Rules. A total of Zidolam-N amounting to ₹ 106.86 crore was cleared under Deemed Exports by the EOU and hence, the above transaction cannot be treated as exports under SEZ Act.

DoC in their reply (June 2014) stated that SEZ Unit may, in terms of Rule 43(b) of SEZ rules, on the basis of annual permission from the Specified Officer, undertake sub-contracting for export on behalf of a DTA exporter, subject to condition that finished goods shall be exported directly by the Unit on behalf of the DTA exporter provided that in case of sub-contracting on behalf of an EOU or EHTP unit or STPI unit or Bio-technology Park unit, the finished goods may be exported either from the Unit or from the EOU or EHTP unit or STPI unit or Bio-technology Park unit. Accordingly the decision was taken.

Rule 43(b) provides for Sub-contracting for Domestic Tariff Area unit for export – A Unit may, on the basis of annual permission from the Specified Officer, undertake sub-contracting for export on behalf of a Domestic Tariff Area exporter, subject to following condition that finished goods shall be exported directly by the Unit on behalf of the Domestic Tariff Area exporter provided that in case of sub-contracting on behalf of an Export Oriented Unit or an Electronic Hardware Technology Park unit or a Software Technology Park unit or Bio-technology Park unit, the finished goods may be exported either from the Unit or from the Export Oriented Unit or Electronic Hardware Technology Park unit or Software Technology Park unit or Bio-technology Park unit.

The reply is not acceptable to audit as proviso to Rule 43(b) of SEZ Rule specifically prescribes that the finished goods manufactured on sub-contracting basis are to be mandatorily exported either from the Unit or from the EOU. Further, the 'condition of export' is referred to in SEZ Rules which does not include deemed exports.

### 5.21 Irregular grant of permission to clear non-SEZ goods as unutilized SEZ goods resulting in short levy of duty

The goods imported by any SEZ units, if remained unutilized, may be allowed to be sold in DTA under the provisions of Rule 34 of SEZ Rule 2006 on payment of applicable duties. Rule 25 of SEZ Rule 2006, states where an entrepreneur or Developer does not utilize the goods or services on which exemptions, drawbacks, cess and concessions have been availed for the authorized operations or unable to duly account for the same, the entrepreneur or the Developer, as the case may be, shall refund an amount equal to the benefits of exemptions, drawback, cess and concessions availed.

M/s. Coastal Energy Systems, an SEZ unit in Falta SEZ, West Bengal imported 5065 MT of "Palm Fatty acid" worth ₹ 17.87 crore (average rate @ ₹ 35280/PMT) during April 2008 to August 2008 with total duty exemption involving ₹ 5.67 crore**.** However, the unit did not bring the goods into SEZ premises and stored it in warehouse tank at port and after expiry of six to eight months the unit requested the DC, FSEZ (February 2009) to allow these raw materials to be cleared as unutilized raw materials of SEZ units. The DC, FSEZ permitted the said goods to be cleared in DTA. Subsequently, the unit brought the goods into the FSEZ and cleared 5003 MT in DTA in several phases in 2009 at an abnormally low declared value (@₹ 13750/PMT) compared to imported price (i.e. almost one third of import value) and the duty was also assessed on the declared price without taking into consideration the import price of the goods at the time of importation.

As the goods were not even brought in to the SEZ unit, the said goods, as per Section 2(o) of SEZ Act 2005, was not to be considered as imported goods of the SEZ unit and the same should not have been allowed to be cleared in DTA with status of SEZ goods attracting the relevant provisions of SEZ Act 2005 and SEZ Rule 2006. Moreover, even if the unit was allowed to clear the said goods as unutilized SEZ goods the unit was supposed to pay the duty equal to the duty exemption of ₹ 5.50 crore availed at the time of its import in SEZ instead of duty paid at the time of its clearance (i.e. ₹ 2.08 crore) in terms of the provisions of Rule 25 of SEZ Rule 2006. Non-observance of the provision of the SEZ Rules, as discussed above, resulted in short levy of duty to the extent of ₹ 3.42 crore.

DoC in their reply (June 2014) stated that once permission for sale of the unutilised goods into the DTA was granted under Rule 34, it had got overriding effect over Rule 25.

The fact remains that Rule 25 and Rule 34 are contradictory as both the rules provide for clearance of unutilised goods into the DTA. However, provision of Rule 34 may be a route for misuse of the SEZ scheme by way of selling the imported goods to the sister units in DTA at much lower value paying less duty.

### 5.22 Customs duty on electrical energy supplied by SEZ to DTA unit

As per section 60(1) of Finance Act 2010 w.e.f 26 June 2009 electrical energy supplied by SEZ to DTA and non-processing zone of SEZ will attract 16 per cent BCD. The rate was revised downwards wef 06 June 2010 wherein rate for power projects below 1000 MW using imported coal as fuel was reduced to ₹ 40 per 1000kwh. The rate was further reduced to NIL rate of BCD w.e.f 18 April 2012. As per customs notification No 45/2005 dated 16 May 2005 the exemption in respect of special additional duty under subsection(5) of Section 3 of Customs Tariff Act 1975 is not available for the goods sold in DTA from SEZ when the goods are exempted from the payment of sales tax or VAT.

As per SEZ instruction 67 dated 28 October 2010 for implementation of customs notification No. 91/2010 dated 06 June 2010 it was decided that operation of Rule 47(3) of SEZ Rules 2006 which is regarding sale of power from SEZ to DTA would be kept in abeyance w.e.f 06 September 2010. SEZ instruction 75 dated 07 February 2011 was also issued modifying instruction 67 that Rule 47(3) of SEZ Rules is kept in abeyance w.e.f 06 June 2010. Further, no instructions have been issued.

The duty leviable for the DTA sale of power from SEZ to DTA in M/s Himatsinghka Linens an SEZ unit in KIADB-Textile Zone, Bangalore for the period upto 5/9/2010 worked out to ₹ 1.34 crore and duty not levied due to

Rule 47(3) of SEZ Rules 2006 being kept in abeyance for the period 06 June 2010 to March 2013 amounted to ₹ 1.56 crore.

Similarly, in Gujarat M/s Adani Ports' Co-developer paid duty of ₹ 13.50 crore (under Rule 47) for power sold to DTA upto 5 September 2010 as against ₹ 46.62 crore (@16 per cent) and thus differential duty of ₹ 33.12 crore could not be recovered. Further, the Developer moved Hon'ble High Court and got interim relief and has paid the duty under protest. The Developer was asked to take BG on the differential duty but the Developer did not take BG stating that it amounted to payment of double duty.

DoC in their reply (June 2014) stated that due to ambiguity/ inconsistency in Rule 47 (3) of SEZ Rules, 2006 which provides for surplus power generated in a Special Economic Zone's Developer's Power Plant in the SEZ or Unit's captive power plant or diesel generating set may be transferred to DTA on payment of duty on consumables and raw materials used for generation of power subject to specified conditions, the rule has been kept in abeyance and at present the Customs duty is being recovered only in accordance with Section 30 of the SEZ Act, 2005. Regarding Bank Guarantee, the matter is under examination for further necessary action.

Reply of the department is not acceptable to audit as the rule was kept in abeyance w.e.f 6 June 2010 and the ambiguity/ inconsistency could not be settled even after four years. In absence of a rule, the risk of revenue loss could not be ruled out.

### 5.23 Incorrect permission to exit under Zero duty EPCG Authorization

As per Rule 74 of SEZ Rules, DC may permit a unit to exit from SEZ on payment of duty on capital goods under the prevailing EPCG (Export Promotion Capital Goods) scheme under the FTP subject to the unit satisfying the eligibility criteria under that scheme.

M/s. Essar Steel Ltd. Kasez, Gujarat applied (9 September 2009) for exit from SEZ. The unit was granted In-Principle exit order (17 September 2009) and final exit order on 28 September 2010. It was noticed that Unit initially opted to exit under 3 per cent EPCG scheme and was already issued three EPCG authorizations (2009) out of which the first one was partly utilized by the unit.

Initially at the time of application of exit under EPCG, finished products of the unit were not eligible for zero duty EPCG scheme. However, in new FTP announced on 23 August 2010 the same was made eligible for zero duty EPCG scheme. Though the unit was already issued three EPCG authorizations under 3 per cent scheme, unit requested DC on 25 August 2010 to recommend issuance of fresh zero duty EPCG authorizations and surrender of earlier authorizations. Unit surrendered all the existing three EPCG authorizations to RA on 25 August 2010 and the unit was issued fresh zero duty EPCG authorization with CIF value of ₹ 8,344.98 crore and duty saved value of ₹ 1,994.03 crore. It was noticed that fresh EPCG authorization was applied on the pretext of a change in the name of the company. The name of the Company was changed as per permission dated 19 August 2010 by DC, KASEZ. This resulted in permitting the SEZ unit to exercise option two times instead of once and consequent grant of undue benefit to the extent of ₹ 257.86 crore.

It was also noticed that out of the total value of ₹ 8344.98 crore considered for zero duty, EPCG authorization includes ₹ 403.36 crore worth of goods (procured during 1.7.2010 to 22.8.2010) which was not certified by valuer (M/s. Mecon Ltd., a GOI enterprise).

On this being pointed out, it was replied (December 2013) by RA, Surat that department had considered the positive NFE criteria before allowing exit and option was exercised for once as zero duty authorisation for final exit.

A case in respect of Tamilnadu is highlighted in Box No.14 where assessment could not be done in the absence of enabling provisions.

**Box 14: No time frame set for assessing the duty on de-notification**

MOC&I approved (March 2013) de-notification of a portion of land measuring 25.07 hectares in M/s. Flextronics Technologies India Private Limited, a Developer in Tamilnadu wherein the Developer had utilised duty free concessions. However, no assessment could be made by the department till date (March 2014) to quantify the duty liability on such duty free benefits availed on de-notified land. The developer engaged a chartered engineer and arrived at the value of duty/tax liability as ₹ 4.83 crore which could not be recovered till date as the department failed to make the assessment even after a lapse of almost one year.

DoC in their reply (June 2014), in respect of M/s Essar Steel Ltd., stated that whenever there is saving of duty on an EPCG authorization there is correspondingly an export obligation fixed which is equivalent to certain times of duty saved. So if the unit saves more amount of duty, more liability in the form of export obligation is fixed. Further, this is not a case of exercising option two times to exit the SEZ scheme. The unit was allowed once to exit under EPCG scheme, the unit surrendered its first EPCG authorization obtained under 3 per cent EPCG scheme and obtained a fresh EPCG authorization when zero duty EPCG scheme became available and in respect of M/s Flextronics Technologies, developer, DoC stated that the developer was not granted exit to operate under EPCG Scheme. The developer was granted approval for partial de-notification of SEZ by BoA subject to clearance from State Government and payment of applicable duties. The SEZ is not yet partially de-notified, and a conditional NOC received from State Government are being processed/examined. Further report in this regard will be sent shortly.

Reply in respect of M/s Essar Steel Ltd. is not acceptable as unit had exercised option two times as three authorisations were already issued to the unit of which one was also partly utilised and again on surrendering existing authorisation zero duty EPCG authorisation were issued which was more beneficial to the unit. Goods procured during July 2010 to August 2010 remained unvalued though the same was required to be valued as done for the prior period. Final outcome in respect of M/s Flextronics Technologies may be intimated to audit.

### 5.24 Examination of goods at premises other than at the Factory Gate

In terms of sub-Rule 11 of Rule 27 of SEZ Rules, 2006, examination of any import or export of goods or those procured from DTA shall be carried out at the SEZ gate or if the same is not possible, in an area, so notified by the Specified Officer for this purpose and no examination shall be carried out in the premises of the Unit.

We noted in respect of J Matadee SEZ and State Industrial Promotion Corporation of Tamil Nadu (SIPCOT), Sriperumbudur SEZ that the Authorized Officers (AO) posted in the SEZ were not carrying out these functions at the respective SEZ Gates but from other SEZ Units. Since the AOs were functioning far away from the SEZ Gate, there was no control at the SEZ gate resulting in lack of proper monitoring of duty free movement of goods at the Gate.

An instance of fraud had occurred in the M/s Dell India Private Limited, an SEZ Unit in SIPCOT SEZ involving misappropriation of 1794 laptops aggregating to ₹ 5.50 crore out of which ₹ 30 lakh in cash and 565 laptops were recovered and sold by the unit subsequently. However, the cost of the balance laptops (numbering 1229) amounting to ₹ 3.70 crore net of recovery of ₹ 30 lakh was written off from stock as per Note 47 to the Financial Statements.

Incidentally, AO of SIPCOT SEZ was functioning from this unit only. However, It could not be confirmed whether the AOs were informed of the fraud that had taken place in the unit. Consequently, the duty forgone amount of ₹ 0.44 crore calculated at 12 *per cent* of the written off value of goods amounting to ₹ 3.70 crore could not be realised. Proper monitoring of clearances of goods and control over the movement of goods at the SEZ gate could have been avoided such fraudulent removals.

DoC in their reply (June 2014) stated that entire FALTA Zone is covered by boundary wall having 2 gates which are manned by Security Officer. Without Gate Pass as issued by authorised Officer nothing can be taken out from the Zone.

Regarding the case of M/s Dell India Pvt. Ltd., it was stated that the misappropriation was identified to have been committed by an employee of the company. It may be stated that the misappropriation was the criminal act committed the individual and it may not be appropriate to hold the company responsible for the misappropriation. Further, Rule 75 of the SEZ Rules does not mandate examination of every consignment. Regarding functioning of the AOs of the SEZ in the premises of M/s. Dell India Private Ltd., DoC stated that SIPCOT, the developer of the building had not provided proper building in the SEZ for functioning of the Customs officers and the environment surrounding the building was unsafe for the officers to function and discharge their duties. Since 80 per cent of the workload of the SEZ relates to M/s. Dell India Pvt. Ltd., and the Unit volunteered to provide accommodation, the Customs officers are functioning in the unit's premises. However, SIPCOT has been asked to provide suitable space for the Customs officials at the entry point in order to incoming/outgoing goods.

Audit is of the opinion that the provisions of sub-Rule 11 of Rule 27 of SEZ Rules, 2006, was not followed in these cases DoC may take necessary action for proper monitoring of duty free movement of goods at the Gate.

### 5.25 Inclusion of DTA Sales in foreign currency terms for the purpose of trading activity

In terms of explanation under Rule 76 of the SEZ Rules, 2006, trading shall mean import for the purposes of re-export, whereas instructions to the contrary were issued by MOC&I vide Instruction No. 49 dated 12 March 2010 allowing trading of goods from DTA to SEZ or from SEZ to DTA in foreign currency terms.

M/s Unblock India Private Limited, a SEZ unit in J Matadee Free Trade and Warehousing Zone (FTWZ) imported granites worth ₹ 8.58 crore involving duty forgone of ₹ 1.26 crore and traded the goods to 100 *per cent* EOUs for ₹ 7.08 crore in foreign currency during the period 2012-13.

Since the EOU Scheme administered under the FTP, 2009-14 provides for sale of manufactured goods in DTA upto 50 *per cent* of the FOB value of products exported, on concessional rate of duty, there is every possibility of the traded goods being sold in DTA on payment of concessional rate of duty after carrying out the process of manufacture.

Thus, the instructions cited above encourage the SEZ units to trade the goods in DTA which was against the provisions of the SEZ Rules. The duty concession of ₹ 1.26 crore, therefore, allowed in respect of the trading unit was not in order.

DoC in their reply (June 2014) stated that SEZ Rule 76 should be read with the definition of Section 2(z) of SEZ Act where it is categorically envisaged that it should be against earning foreign exchange only. As per Rule 76 of SEZ Rules, 2006, the expression "trading" for the purpose of second schedule of the Act, shall mean import for the purpose of re-export. Hence, this condition is only for the purpose of income tax exemption. Otherwise, trading from DTA to SEZ and from SEZ to DTA is allowed. Further, EOUs are not supposed to clear goods as it is, in the DTA. They are supposed to clear only those goods which are manufactured by them. In case of raw materials remaining unutilized, they have to follow the prescribed procedure which includes approval from Customs/Excise authorities.

Reply is not acceptable to audit as the issue raised here is issue of Instruction No. 49 dated dated 12 March 2010 allowing trading of goods from DTA to SEZ or from SEZ to DTA in foreign currency terms in contrary to the SEZ Rules.

### 5.26 Utilization of goods and services for unauthorized operations[16]

In terms of sub-rule 9 and 10 of Rule 11, the Developer shall not sell the land in a SEZ and vacant land in the non-processing area shall be leased for social purposes such as residential and business complexes, to a co-developer approved by the Board who, in turn, may lease the completed infrastructure along with the vacant land appurtenant thereto for such purposes. Further, the Developer or Co-Developer shall strive to provide adequate housing facilities not only for the management and office staff but also for the workers of the SEZs/Units. The SEZ Rules further provided that any such infrastructure created in addition or in excess thereof shall not be eligible for any exemptions, concessions and drawback.

In terms of Rule 25 of SEZ Rules 2006, where an entrepreneur or Developer does not utilize the goods or services for the authorized operations shall

[16] A Para has been included vide 4.9.11 (Chapter IV) of Report No. 1 of 2013-Tamilnadu- Revenue Sector on sale of Residential Flats in SEZ Area wherein we have quantified ` 8.68 crore as registration charges. However, here we are quantifying other Direct/Indirect taxes benefits wrongly availed by the Developers.

refund an amount equal to the benefits of exemptions, drawback, cess and concessions availed without prejudice to any other action under different Acts.

a) Three co-developers[17] in Mahindra World City SEZ, Chengalpattu, Tamilnadu obtained LoA between April 2006 and April 2008 for carrying out authorized operations in the non-processing area for construction of residential houses after availing duty concessions / exemptions on the imported / procured inputs and Capital Goods.

We noted that the residential buildings constructed on such leased lands, by the co-developers, were sold to individuals unconnected with the authorized operations of the Zone, by camouflaging 'Sale Deeds' as 'Perpetual Lease' agreements with a lease term of 99 years on receipt of valuable consideration. This activity of the co-developers was in violation of SEZ Rules cited *supra* and hence ineligible for the benefit of duty concession on the imported/procured inputs and capital goods to the extent of ₹ 7.83 crore which is required to be recovered.

In addition, Sales Tax/VAT concessions amounting to ₹ 7.09 crore and service tax to the tune of ₹ 8.27 crore was recoverable along with applicable interest from the developer.

(b) Similarly, another developer (New Chennai Township Pvt. Ltd.) in Cheyyur, Tamilnadu obtained two formal approvals on 23 May 2007, one for setting up of SEZ for engineering sector and another for multi-services SEZ. The developer was permitted to construct 7500 residential apartments in the non-processing areas of each SEZ.

We noted that the developer had proposed to construct 4620 and 2068 apartments in the non-processing area of both the SEZs, out of which 300 and 280 apartments respectively had been completed. The developer entered into lease deeds for a perpetual lease term of 99 years, against payment of one time lump-sum premium, with the lessees who are not connected with the authorised operations of the zone which is in violation of the provisions prescribed in Rule 11.

Further, scrutiny of the pamphlets/brochures of residential apartments distributed by the Developer revealed that the number of dwelling units constructed is far in excess of the actual employment generated (approx. 500) by the nine SEZ Units situated in the Zone which clearly indicates that

[17] Mahindra Integrated Township Limited, Mahindra Residential Developers Limited and Mahindra Lifespace Developers Limited (Mahindra Gesco)

the apartments were constructed mainly for selling it to outsiders on commercial profit, in violation of SEZ Rules.

In view of the above, the operations carried out by the Developer were unauthorized and hence ineligible for the benefit of duty concession on the imported/procured inputs and capital goods availed to the extent of ₹ 9.55 crore which is recoverable along with applicable interest.

In addition, Sales Tax/VAT concessions availed to the extent of ₹ 9.53 crore and service tax amounting to ₹ 3.03 crore for their services rendered is also recoverable along with applicable interest.

DoC in their reply (June 2014) stated that action has been initiated to issue demand, SCN for recovery of duty wrongly availed. Further, action has been initiated under FTD&R Act, 1992 against the three co-developers of Mahindra World City SEZ and New Chennai Township Ltd. regarding illegal allotment of Residential Units to persons not connected with the SEZ.

DoC may intimate the final outcome to audit.

### 5.27 Failure to recover cost recovery charges

The Department of Personnel and Training vide their O.M. No.6/8/2009- Estt. Pay II dated 17.6.2010 read with SEZ Guidelines dated 16th September 2010 stated that the cost recovery of all expenses towards pay and allowances of staff sanctioned and posted in the notified SEZs are to be collected from the developers.

We noted that an amount of ₹ 4.63 crore was outstanding in respect of 59 Developers as on June 2013 in Andhra Pradesh, Maharashtra, Karnataka, Kerala, Odisha, Gujarat and West Bengal.

Further, the issue of custodianship of imported/export cargo within the International Container Transhipment Terminal (ICTT) at Vallardapam, SEZ and payment of cost recovery charges for the officers posted at ICTT remains un-resolved.

Audit is of the opinion that approvals for activities in the non-processing area are not commensurate with the operations in the processing area to prevent SEZ units becoming real estate business establishments.

DoC in their reply (June 2014) stated that regarding posting of officials in the private SEZs on additional charge basis, it is informed that in order to examine the development (specially construction) of the proposals as submitted by the private SEZ, the officials are posted in addition to their existing duties. Raising of demand to any Developer appears feasible when at least one unit of the Developer becomes operational and recruitment of officers on deputation basis as per existing norms is done on regular basis. As the example cited by the Audit the Project of respective Developer has not been materialized and the SEZ was not operational the raising of demand towards cost recovery charges does not arise. However, proportionate cost recovery as suggested by Audit will be followed on operational SEZs.

Action for recovery has already been initiated by the respective zones. The actual recovery of amount in accordance with the dues will be intimated shortly.

DoC may intimate the final outcome to audit.

### 5.28 Outstanding lease rentals, water charges and maintenance charges

Section 34(1) and (2) of SEZ Act 2005 stipulates that SEZ Authority can undertake measures as it thinks fit for the development, operation and management of the Special Economic Zone for which it is constituted. The Authority shall be responsible for development of infrastructure and can levy user or service charges or fees or rent for the use of properties belonging to the Authority.

We noted from the records of the concerned SEZ Authorities in Andhra Pradesh, Gujarat, Madhya Pradesh, Maharashtra, Rajasthan, West Bengal and Uttar Pradesh that a sum of₹ 49.33 crore remained pending as of June 2013 on account of various services rendered by the Authority to the unit holders viz., lease rentals, service charges, maintenance charges, etc.

DoC in their reply (June 2014) stated that lease rentals, services charges, maintenance charges are monitored/recovered regularly except the cases which are sub judice or are registered under BIFR. All out efforts are made to recover the dues including by issuing Recovery Certificates to the concerned Collector/District Magistrate.

DoC may intimate the final outcome to audit.

### 5.29 Exemption on payment of Stamp duty-failure to recover dues

The Indian Stamp Act, 1899 as amended through Section 57 of the SEZ Act 2005 stipulates that no duty shall be 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 purposes of the Special Economic Zone.

Instructions of MOC&I issued in July 2009 stipulates that when a SEZ is not commissioned within the time indicated by the MOC&I in the approval, or if the SEZ notification is cancelled, the State Governments will be entitled to withdraw the concession of stamp duty and recover the same from the developer.

We observed in eight cases in Andhra Pradesh, Gujarat, Uttar Pradesh and Odisha that the stamp duty exemption availed while registering the lease deed was not recovered on de-notification thereby resulting in a loss of ₹ 8.56 crore to the concerned states. In case of M/s Vivo-biotech and M/s Maytas Ventures, the Government of Andhra Pradesh issued NOC without quantifying the exemption availed on stamp duty.

DoC in respect of Welspun Anjar SEZ stated (June 2014) that the developer had purchased land directly without availing the benefit of stamp duty concession and after notification of SEZ entered into an agreement with the units for leasing of land. It is the case of stamp duty on the said lease. The Audit has pointed out while completing formalities for exiting, the developer had not refunded the said stamp duty. This Administration had received NOC from Industrial Commissioner, Gandhinagar which encloses a NOC about stamp duty paid back issued by Addl. Supdt., Stamp Duty & Valuation Deptt. The audit objection has since been referred to the State Govt. for appropriate reply.

As far as de-notification of M/s. IVR Prime is concerned, though LOA has expired, however the SEZ has not yet been de-notified. Stamp duty shall be recovered prior to de-notification of SEZ. Wherever a SEZ is de-notified, all duties are recovered including stamp duty.

In respect of Sri City SEZ, DoC stated that as per Govt. of A.P., State Support Agreement dated 25.06.2008, 'GoAP has agreed to the formation of a SEZ and DTA both collectively referred to as the "Project". It also states under the Definition & Interpretation the word "Land" as more fully defined as SEZ and an accompanying DTA, all comprising "Special Investment Region". That was the reason based on the request of the developer of Sri City SEZ (Multi Product) had been recommended to BoA for de-notification without insisting on payment of Stamp Duty to GoAP. The intention would have been that the land will ultimately be utilized/allotted to the Industrial Units in DTA thereby the purpose for which land was allotted to the developer will be served.

DoC may furnish replies on other cases to audit.