Tax Policy for SEZs – A Note

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Introduction: Several countries use Special Economic Zones[1] (SEZ) as a means to kick start investment in areas when providing a conducive environment for investment in the general area (such as infrastructure, regulatory barriers, availability of land, etc) is difficult in the short term. SEZs have historically predominantly directed to encourage export oriented investment. The main types of SEZs are Export Processing Zones (EPZ), Free Trade Zones (FTZ), Freeport, Enterprise Zones, etc. All these different classes of Zones share the following principal characteristics:-

- A Geographically delimited area, usually physically secured (fenced-in)
- Single management/administration
- Eligibility for benefits based upon physical location within the zone
- Separate customs area and streamlined procedures[2].

These benefits such as serviced land, access to electricity, water and a location that is well connected to the main trading centers allow businesses to set-up and start their operations quickly. SEZs may be developed by governments or even the private sector. Apart from these benefits, some countries offer a special tax regime for those businesses operating out of the Zone. Tax Exemptions offered for businesses located inside the SEZ include exemptions from,

- Border Taxes such as Import Duties and Import VAT
- Corporate Income Tax exemptions for enterprises located within the SEZs and for Zone developers
- Personal Income Tax on employees
- Permit Fees and Service Charges
- Rental and Sales fees (from sale of rental of public land to developers)
- Import Duties and Taxes on zone products sold to the domestic customs territory
- Concession Fees for other facilities (port, power plant and so on), linked to zone operation and development

The most common feature of SEZs are exemptions from border taxes. A major benefit for enterprises operating out of the SEZs as a result of this includes improved cash flow from not having to pay Customs Duty and VAT upfront (and claiming them on export later in the usual case) and the reduced the cost of compliance for them.

However, tax exemptions result on loss of tax revenue for governments and involve costs for the tax administration as well as for businesses for complying with them.

This note summarizes some of the principles that such an SEZ tax policy should be based on and provides recommendations based on them.

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[1] Typically a SEZ is a geographically contiguous area, though this may not always be the case.
[2] "Special Economic Zones – Performance, Lessons learned, and Implications for Zone Development, Investment Climate Advisory Services", 2008. The World Bank Group.

Principles of Taxation: In general there some good principles that any tax policy should follow. This applies to direct taxes such as Income Tax as well as indirect taxes such as VAT and customs duty.

1. **Simplicity:** Tax policy should as far as possible, be simple and easy to implement. In cases where the sector is itself quite complicated (such as Finance), the tax policy governing it should not aggravate the complexity. This principle also includes making tax policy simple enough to reduce opportunities for tax evasion and aggressive tax avoidance.

2. **Efficiency:** Tax Policy should as far as possible limit the distortions on investor behavior. Taxation in general make investors change their behavior to adjust for the costs that it imposes on them. In the case of Incentives (tax or non-tax), the goal is on the other hand to change investor behavior in a desired direction. However, in this case the distortion may not necessarily be good as it may not be beneficial for the economy a whole and this imposes economic costs. Tax evasion is another reflection of distortions in taxpayer behavior.

3. **Administrative Feasibility:** Tax policy should be designed in a way such that it is easy to administer. Complying with Tax Policy imposes costs on the businesses as well as costs on tax administration to ensure compliance. Such costs need to be minimized. This principle also implies that the tax policy should ensure that evasion could be controlled with least compliance costs imposed on taxpayers.

Issues arising out of tax Policy for SEZs

Based on the principles outlined above, one could analyze the various options when designing a separate tax system for SEZs.

1. Should Income Tax laws for a business situated inside SEZs be more beneficial as compared to one outside?

   If one invokes the principles above, it is recommended that the income tax law applicable should be the same because of the following:-

   a. Different income tax provisions for businesses inside and outside the zone increases the complexity of the tax system. The complexity arises from different rates for the different taxes inside and outside the SEZ, different procedures, different accounting, etc. It becomes especially complex when there are enterprise(s) that are situated inside the SEZ and outside the SEZ that are owned by one taxable entity. The tax policy should in this case take into consideration the allocation of the proper costs and incomes across the different entities across the different tax regimes.

   b. It creates distortions in behavior of taxpayers as follows:-
      i. Businesses that are located outside the SEZ and usually paying taxes would prefer to relocate their operations into the SEZ resulting in paying lesser tax while not creating any additional investment.

      ii. Businesses located outside the SEZs may ‘transfer’ their profits to those inside the zones. Such a transfer may happen among related as well as unrelated parties. In such cases, the costs of the enterprises outside the zones are overstated (while those inside the zone would under stated). Similarly, the incomes of enterprises outside the zone would be under stated (while those inside the zone would be over stated). Hence, while the total incomes and costs are the same, their allocation across the different tax regimes results in lower profits (and hence lower tax) for those outside the zone, while those inside the Zone show higher profits but that are taxed at a lower rate. Overall this results in loss of tax revenue.

c. The additional complexity as well as opportunities for tax evasion raises the administrative costs for the tax administration (additional audits, tax officials, etc). The Tax Administration in turn and imposes higher compliance costs on businesses in the form of additional information requirements, audits, etc.

2. What about Customs Duty exemptions on imports into the SEZ?

   As in the case of Income Tax exemptions this also introduces some of the distortions as above especially the pressure of customs duty evasion. If goods used inside the SEZ are exempt from duty while not if destined outside the SEZ, the challenge is to ensure that there is no leakage of duty free goods outside the SEZ. This requires physical controls on the movement of goods which in turn imposes additional administrative as well as compliance costs. Hence, it is important to ensure that the SEZ is a well defined contiguous area with good control of entry and exit of goods into and out of the SEZ, including ensuring that there is full control of the movement of goods from the first point of entry into the country until the SEZ.

   There are cases where a self standing business is declared as a SEZ. In such cases, duty exemptions are not recommended as the control of flow goods is generally much harder to maintain and is costly to enforce.

3. Should VAT be exempted/refunded for sales made to businesses located inside the SEZ?

   This is not recommended as it is difficult to enforce and increases complexity of the tax administration. This is sometimes referred to as “indirect exports”. Businesses would need to separate their VAT exempted sales made to SEZ businesses, from their taxable sales and report them accordingly to the tax administration. Further, the same physical controls of the flow of goods as in the case of customs need to be maintained in order for an audit trail to support the claim of VAT exempted sales. In the case of sale of services this again remains difficult. Overall, the administration of the different tax treatment of sales by destination imposes additional costs on the administration as well as on the businesses.

   In case SEZs enterprises are primarily export oriented, the case may be made to exempt VAT on imports made by SEZ businesses. This is because VAT is refunded on export sales and not collecting the VAT in the first place may save administrative costs for businesses as well as the tax administration.

4. Should VAT be exempted on sales made outside the SEZ ?

The businesses located inside the SEZ should pay the regular VAT on all sales made to the domestic area. See 5 below.

5. How does one ensure that domestic as well as SEZ businesses are treated equally?

   This is important to ensure that distortions are minimized as tax benefits accorded to businesses located in SEZs may make put existing businesses located outside the SEZ uncompetitive.

   a. Sales made to the general tariff area

      SEZ businesses may sell finished goods or services to the domestic market however; the tax regime should ensure that they do not put the business located outside at a disadvantage due to the beneficial tax system that the former enjoy. As a result the following needs to be done:-

      i. In the case of Income Tax, any benefit provided should be reduced by the proportion of sales made outside the SEZ. For example if there is a 100% income tax exemption for businesses located inside an SEZ and a business makes 30% of its sales into the domestic market, the tax exemption would be reduced to 70%. The principle is that as far as possible, benefits are enjoyed by the SEZ businesses as well as those outside the SEZ should be the same.

      ii. Similarly, VAT and Customs Duty exemptions claimed would have to be paid on the goods that are sold into the domestic market

      iii. For the same reason, the regular VAT on sales made to the domestic area should be applied or else they would out-price the domestic businesses.

   b. Exports Sales made by SEZ businesses

      The Tax policy should ensure that any benefits accorded to businesses located inside the SEZ on exports is the same as those enjoyed by businesses located outside.

6. Should SEZ developers be provided any tax benefits?

   Private sector SEZ developers create infrastructure which then ensures that other businesses may be able to operate. Hence they provide a quasi-public good because the benefits they provide to the economy more than make up for the financial costs (positive externality). Hence it is recommended that they be accorded similar tax benefits as those that are provided to other infrastructure providers.

7. How should we treat mixed-use SEZs, where some businesses inside the SEZ are primarily manufacturing and/or exporting while others provide services to them?

   As long as the businesses inside the SEZs are only servicing clients inside the SEZ, their tax treatment may be different from those outside. However for, any services provided to businesses outside the SEZ the regular tax laws should apply. As mentioned above, this increases the complexity of the tax system putting pressure on the tax administration to ensure that this does not result in leakage of tax. Further, businesses also have to maintain proper records to allow its administration.

Conclusion: SEZs are used in several countries to give a boost to manufacturing and to exports. By providing good infrastructure, the businesses located inside the SEZs are already at an advantage over those located outside. Providing a beneficial tax regime over and above this places businesses located outside the SEZ at a further disadvantage resulting in loss of business and employment. Overall the goal should be to ensure that the entire country should have as good business climate as well as infrastructure as that provided inside the SEZ. Tax policy should be neutral as far as possible and apply similarly regardless of the location of the business.