Annexure ‘A’

***Issue 1**: The incentive is available with respect to the amount transferred to the SEZ Reinvestment Reserve and utilised therefrom in the manner laid down. There is no clarity on how the reserve should be utilised by the taxpayer. That is, can it be utilised by any undertaking (whether SEZ or STP or otherwise) of the taxpayer or should the reserve be utilised only by an SEZ unit of the taxpayer? Or, should it be utilised by the SEZ unit that created the reserve?*

Creation of SEZ Reinvestment Reserve

Section 10AA(1)(ii) of the Act provides for mechanism of creation of SEZ Reinvestment Reserve. As per the provision, a SEZ Reinvestment reserve is created by transferring the profits of the previous year to a special reserve account, by way of a debit to the profit and loss account and credit to the “Special Economic Zone Reinvestment Reserve Account”. The reserves are disclosed under “Reserves and Surplus” in the balance sheet.

Utilisation of SEZ Reinvestment Reserve

Section 10AA(1)(ii) provides that the SEZ Reinvestment Reserve should be utilised for the purpose of *business of the assessee* in the manner laid down in sub section (2). Thereby, the subsection does not place any restriction by limiting the usage of reserve by an undertaking which are however subject to conditions prescribed under subsection (2).

As per Clause (a) of Subsection (2) of the Act, the SEZ Reinvestment Reserve may be utilised:

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

On a combine reading of subsections (1) and (2), the anomaly which arises is, the meaning of the phrase “*business of the assessee*” in subsection (1)(ii) as against the phrase *“business of the undertaking”* in subsection (2)(a)(ii). The anomaly gives rise to questions as to whether SEZ Reinvestment Reserve can be used for

- Any of the undertaking (whether SEZ or STP or otherwise) of the assessee; or
- Any of the undertaking being an SEZ unit of the assessee; or
- Only that SEZ Undertaking whose profits were used for creation of the reserve

The text of Section 10AA uses the words / phrases “undertaking”, “unit” and “undertaking, being a unit”. Hence, in order to appreciate the intention of provision contained in subsection (2), it is important to interpret and analyse these terms.

Interpretation of terms ‘undertaking’, ‘unit’, and ‘undertaking being the unit’

A. The term “Undertaking”

Special Economic Zones Act, 2005 was enacted for establishment, development and management of SEZ’s and for promotion of exports. The Act also bestowed various direct and indirect tax benefits to the units commencing manufacture in SEZ. Special Economic Zone Act, 2005 (*Section 27 read with Second Schedule*) provided for modifications to the Income-tax Act, 1961 (“the Act”) by introducing a new section 10AA specifically for the benefit of assessee’ commencing manufacture in a SEZ.

The term ‘undertaking’ is used under several sections *(Section 10AA, 50B, 80-IA, 80-IB, 80A)* of the Act. The Act defines the term undertaking *(Explanation 1 to Section 2(19AA) in the context of demerger)* to include any part of the *undertaking or unit or division* of an undertaking or a business activity taken as a whole, but not to include individual assets or liabilities or any combination thereof not constituting a business activity.

The term “undertaking” is defined under the Companies Act, 2013 *(Explanation (i) to Section 180(a) of the Companies Act, 2013 in the context of restriction of the board to sell, lease or otherwise dispose off the undertaking)* as an undertaking in which the investment of the company exceeds twenty per cent of its net worth as per the audited balance sheet of the preceding financial year or an undertaking which generates twenty per cent of the total income of the company during the previous financial year;

The meaning of the term “undertaking” has also been well discussed out of various jurisprudence such as Textile Machinery Corporation Ltd vs. CIT *[107 ITR 195]*, CIT vs. Associated Cement Companies Ltd.[*118 ITR 406],* CIT vs. Premier Cotton Mills Ltd [240 ITR 434].

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Based on the definition of undertaking under various statues and interpretation by judicial precedents, it could be concluded that:

i. An undertaking would include any unit or division or undertaking of the assessee;
ii. which can be independently identified by the assessee and functions in its independent capacity
iii. through which the assessee carried out the business activity.

B. The term “Unit”

The term “unit” is not defined under section 10AA of the Act. However, subsection (10)(v) of Section 10AA makes a reference to the definition as provided under Section 2(zc) of Special Economic Zone Act, 2005. SEZ Act, 2005 defines “unit” to mean a Unit set up by the entrepreneur in a SEZ and includes an existing unit, an offshore banking unit and an unit in international financial services centre, whether established before or after the commencement of the SEZ Act, 2005.

The SEZ Act always makes reference to a “unit” and not an “undertaking” for the purpose of application of provisions, conferring benefits, duties and responsibilities under SEZ Act to the entrepreneur.

The Income-tax Act, under section 10AA also refers to the term “unit”. As may be noted under section 10AA of the Act, the term ‘unit’ which is used from SEZ Act, is always used with the term “undertaking” in so much as required to refer to such undertaking for which the provisions of SEZ Act, 2005 would apply.

Based on the above, it could be concluded that the term “unit” wherever specifically referred to in Section 10AA pertains to only those units for which SEZ Act would apply.

C. “Undertaking” and “Undertaking being a Unit”: Context of usage under Section 10AA

The SEZ Act, 2005 inserted Section 10AA into the Act, 1961. The SEZ Act, 2005 does not make any reference to the term “undertaking” in the entire enactment. SEZ Act refers to a “unit” for imposing the provisions of SEZ Act and conferring the benefits and rights to such Unit. The provisions are qua unit

and not qua undertaking or assesse.

A reading of text of Section 10AA introduced by the SEZ Act makes it amply clear on the intention of usage of the term “undertaking, being a unit” under section 10AA of the Act. The term “*undertaking, being a unit*” and the term “*undertaking*” has been used to clearly make a distinction between the undertaking which is an SEZ unit eligible for benefit under SEZ Act and other undertakings. This is further clarified by section heading which states *“10AA. Special provisions in respect of newly established Units in Special Economic Zones”*. The section heading does not use the word “undertaking”.

It is one of the fundamental cannons of interpretation of statue that omissions in a statue, as a general rule, cannot be supplied by construction. If a particular case is omitted from the terms of a statute, though such a case is within the obvious purpose of the statute and the omission appears to have been due to accident or inadvertence, the court cannot include the omitted case by supplying the omission [CIT v. KS Vaidyanathan 1985 153 ITR 11]. *Casus omissus,* therefore cannot be supplied by judicial interpretative process. Since the primary rule of statutory interpretation is that the intention of the legislation must be found in the words used by the legislature itself, a *casus omissus* should be inferred in case of clear necessity and only after construing all parts of a statute or section together [Unique Butyle Tube Industries (p.) Ltd v. UP Financial Corporation (2003)[2 SEC 455].

Thus, it may be noted that, had the intention of the legislature was to restrict the usage only to SEZ unit, the phrase “*undertaking, being a unit*” would have been used in subsection (2) instead of using the term “*undertaking*”. It is with same intention that in the course of reference made to section 10A(5) and 10A(6) in subsection (8) of Section 10AA, the word “*undertaking*” is substituted with the word “*undertaking, being the unit*”.

From the above, it can be reasonably concluded that the term ‘undertaking’ refers to any undertaking of an assessee, whether claiming deduction u/s 10A, 10AA, etc. or not, and the phrase “*undertaking, being a unit*” refers to an undertaking being a unit in SEZ, eligible for claiming deduction under section 10AA of the Act.

Creating a SEZ Reinvestment Reserve: Intention, when introduced under section 10A

Special Economic Zones Act, 2005 was enacted in the year 2005 which is subsequent to the earlier amendment made to section 10A of the Act. The preamble of the SEZ Act 2005 provides as follows:

> *“An Act to provide for the establishment, development and management of the Special Economic Zones for the promotion of exports and for matters connected therewith or incidental thereto.”*

The SEZ Act, 2005 also bestows various direct and indirect tax benefits to the units commencing manufacture in SEZ. It may be thereby noted that the SEZ Act, 2005 was enacted for special benefits and relief to units located in SEZ. Based on the above, the fact is evident that it is with the same intention that SEZ Act, 2005 inserted Section 10AA into the Income-tax Act, 1961 to confer benefits to SEZ Units.

The concept of creation of a ‘*SEZ Reinvestment Reserve*’ for the benefit of a SEZ undertaking was enacted under section 10A of the Act in the year 2003. The provisions of creation, utilisation and taxation of reinvestment reserve under the then section 10A is similar to that of the existing provision under section 10AA of the Act.

The intention behind creation of a SEZ Reinvestment Reserve for section 10A was clarified by the Central Board of Direct Taxes vide its circular No. 7/2003, Paragraph 18.2, which provides as below:

> *"18.2.* ***With a view to promoting the development of Special Economic Zones****, the existing sub-section (1A) of section 10A has been substituted so as to provide for a further deduction for three consecutive years beyond the existing period eligible for deduction, which shall be equal to 50% of the profits as are credited to a reserve account to be utilised for the purposes of business."*

From the above, it is clear that under section 10A, the object of creating a reserve was to utilise the same for promotion and development of SEZ units and not for any other business of the assessee. Considering the meaning derived

Accounting Nomenclature used: "Special Economic Zone Reinvestment Reserve Account"

Section 10AA provides that the nomenclature of the reserve account to be created by transfer of profits by a SEZ unit should be *"Special Economic Zone Re-investment Reserve Account"*. The term "Special Economic Zone" though defined specifically under section 10A of the Act, *is not so defined* under Section 10AA of the Act. Section 10AA borrows definition from section 2(za) of SEZ Act, 2005 which is as below:

> *"(za) "Special Economic Zone" means each Special Economic Zone notified under the proviso to sub-section (4) of section 3 and sub-section (1) of section 4 (including Free Trade and Warehousing Zone) and includes an existing Special Economic Zone;"*

The above clarifies that the undertaking being a unit for the purpose of claiming deduction under section 10AA should be recognised under the SEZ Act specifically meant for the benefit of such SEZ units.

The terms "Reinvestment" and "Reserve" are also not defined under the Act or under SEZ Act. Hence, the meaning of the terms may be ascertained from external sources. As per law lexicon, "Reinvestment" means a second, additional or repeated investment; and "reserve" means a part of company's undistributed capital (excluding share capital) resulting from retained profits. Based on the said definition and on a combined reading of reinvestment and reserve, it would provide a meaning that it is a *retained profit used for additional or repeated investment*. Since the term Reinvestment and Reserve is used along with the term "Special Economic Zone" it indicates that the purpose of additional or repeated investment is specific and hence can be used by units in SEZ.

Considering the nomenclature of reserve account and importing the intention of creation of reinvestment reserve from CBDT circular, it could be concluded that SEZ Reinvestment reserve should be used for purchase of plant and machinery and for the purpose of business of the SEZ undertaking and not any other undertaking.

Interpretation arising from the utilisation condition mentioned under section 10AA(2)

Subsection (2) of Section 10AA further provides that a SEZ Reinvestment Reserve created should be utilised for the purposes of the business of the undertaking other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India.

A reserve, as accounting parlance and practice goes, is an appropriation of profits and such profits have to be ascertained only at the end of the year and for the concern as a whole. A reserve is a mass of un-earmarked profits and it cannot be identified with any particular unit or department while making up the accounts of a company under the Companies Act.

Considering the above, it could be interpreted that had the intention been limited to usage of reserve for a specific undertaking, the above mentioned requirement of utilisation of reserve for distribution of dividends which can be attributed to the company as a whole, would not be brought into the provision.

Views arising from the above discussions / interpretation

View 1: SEZ Reinvestment Reserve can be used by any undertaking of the assessee

The Apex Court has held in several instances that beneficial provisions, such as exemption provisions (as in the case of section 10AA) are to be interpreted liberally, in favour of the assessee. Accordingly, section 10AA may be interpreted in favour of the assessee in case of an anomaly created under the said section.

Subsection (2) of Section 10AA requires the usage of plant and machinery for the purpose of business of the undertaking.

On interpretations of the terms “undertaking”, “unit” and “undertaking being a unit” as mentioned in Paragraph D.4 above, and judicial precedents and a plain reading of subsection (1) and (2) of section 10AA, it could be reasonably concluded that the funds in SEZ Reinvestment Reserve can be used for any undertaking of the assessee and need not be restricted to the usage of an SEZ unit.

View 2: SEZ Reinvestment Reserve can be used for any SEZ undertaking of the assessee

The legislative intention for creation of reinvestment reserve under section 10A can be understood from Circular No. 7/2003 as mentioned above in Paragraph D.5, a position could be taken that the reinvestment reserve can be used only for the purpose business of an undertaking being a unit in SEZ and not for any other undertaking.

The above conclusion is further supported by the nomenclature used under section 10AA to clarify that the reserve has to be created and utilised for the purpose of business by way of a reinvestment (*and not investment*). Based on the usage of the word “reinvestment” read along with the intention of SEZ Act 2005 and Section 10AA and circular No 7/2003, it signifies that the funds are required to be utilised for same or similar units under SEZ to support the intention laid down by SEZ Act.

Since interpretation can be drawn from clarifications issued by the board by way of a circular, a conclusion could be drawn that ‘SEZ Reinvestment Reserve’ should be used for the purpose of undertaking being a SEZ Unit. This approach is a mid-way approach as compared to view 1.

View 3: SEZ Reinvestment Reserve can be used only by SEZ undertaking which created the reserve

A Special Economic Zone is defined to include each notified SEZ's under SEZ Act[1]. An undertaking established in a SEZ receives special status and enjoys various direct and indirect tax benefits from the government. As discussed in Paragraph D.8 above, a position could be taken that SEZ Reinvestment Reserve should be utilised for the purpose of business of an undertaking being a unit in SEZ and not for any other undertaking. A much narrower interpretation in connection with the above position would be that such utilisation be restricted to only those SEZ units whose funds are being used from the SEZ Reinvestment Reserve.

The above position is be supported by a reference being made to prescribed Form 56FF which the Company[2] is required to file with the Assessing Officer ('AO') providing the particulars of the amounts transferred and withdrawn from the SEZ Reinvestment Reserve during the year. The form requires the authorised signatory to declare that a *specific undertaking situated in a SEZ* has acquired the new plant and machinery, for which purchase price has been paid by making withdrawal from the SEZ Reinvestment Reserve.

Considering Form 56FF as an external aid of interpretation, a conclusion could also be taken that the funds in SEZ Reinvestment Reserve account should be utilised for specific SEZ units and cannot be utilised by all SEZ undertakings.

Conclusion

View I, provides a wide interpretation of the term 'undertaking', to mean any and all business carried on by the assessee, whether or not a unit located in a SEZ. Consequently, the Reserve may be utilised to offset the expenses of any unit / undertaking of the assessee, whether established in a SEZ or not.

View II interprets the term 'undertaking' to mean and include the unit registered under SEZ enjoying the benefits of SEZ Act 2005. Accordingly, the balance in the SEZ Reinvestment Reserve may be utilised by all SEZ units of the assessee. In other words, the funds in SEZ Reinvestment Reserve Account cannot be used for any other undertaking. This view goes with the objective of SEZ act which also incorporated section 10AA into Income-tax Act, 1961.

View III interprets the term 'undertaking', to mean only those SEZ undertakings in respect of which the deduction was originally claimed and profits were allocated to the reserve. Accordingly, the Reserve may be utilised only by those SEZ undertaking whose profits are utilised from the reserve, and no other. View III draws aid from View II and the text mentioned in Form 56FF which further narrows down the applicability.

Hence, in light of the above discussion, litigation in connection with claim of deduction under section 10AA is inevitable.

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[1] Section 2(za) of Special Economic Zone Act, 2005

[2] Section 10AA(2)(b) r.w. Section 10A(1B)(b) and Rule 16DD