

Tax Hotline

January 14, 2005

TAX HOLIDAY AVAILABLE TO DOMESTIC TARIFF AREA UNDERTAKINGS CONVERTED TO EXPORT ORIENTED UNDERTAKINGS

The Central Board of Direct Taxes ("CBDT") in India issued Circular No 1/2005 on January 6, 2005 ("Circular") clarifying the long pending query that undertakings set up in Domestic Tariff Area ("DTA") and subsequently converted to Export Oriented Undertaking ("EOU") would be eligible for income tax holiday under section 10B of the Income Tax Act, 1961.

A tax holiday is available to an undertaking under section 10B of the ITA to an EOU on its export earnings for a period of 10 years beginning from the year in which it begins to manufacture articles, things, computer software ("Qualifying Products"), subject to fulfillment of certain conditions. These conditions are inter alia that the undertaking should not be formed by splitting up or reconstruction of a business already in existence, it should not be formed by the transfer of used plant and machinery in excess of 20% of the total value of plant and machinery used by the undertaking, etc. Note however, that the tax holiday under this section is available only till March 31, 2009.

While a DTA undertaking was permitted to convert itself into an EOU, the same would result in non-fulfilment of the above conditions, and hence this clarification was needed. The Circular has clarified that DTA undertakings converted into EOUs would be able to claim the tax holiday as under:

- The tax holiday shall be available only from the year in which the DTA gets approval as 100% EOU and for the remaining period of 10 years beginning from the period in which the DTA undertaking originally began to manufacture Qualifying Products.
- In the year of approval as EOU, the holiday shall be in respect of export income and will be restricted to such income derived from and after the date of approval for conversion of the DTA undertaking to EOU.
- The tax holiday would be available only for 10 years till March 31, 2009. Hence, if a DTA undertaking is set up in financial year ("FY") 1998-1999 and converted to an EOU in FY 2004-05, the ten year period would start from FY 1998-1999. Therefore, the EOU would be eligible to claim tax holiday from FY 2004-05 till FY 2007-08 and not till the FY 2008-09, when the holiday under section 10B expires.

The Circular gives certain examples to explain the above parameters. One of the examples clarifies that where the DTA undertaking acquired more than 20% used plant and machinery when it started manufacturing Qualifying Products and converted itself to EOU, it would not be eligible to claim the tax holiday. It appears that while a DTA is permitted to use the plant and machinery that it has been using before conversion, if it acquires used plant and machinery exceeding 20% of total machinery in the year of conversion, the tax holiday will not be available.

This clarification will go a long way in providing much needed clarity and reducing litigation, arising out of ambiguity.

Source: CBDT Circular No 1/2005 dated January 6, 2005

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