Customs and International Trade Practice

# Foreign trade zone handbook

Building a better working world

# Contents

# I. Introduction

*What is a foreign trade zone?*

A foreign trade zone is an area that is physically located within the United States, but is considered outside of the customs territory of the United States. The US version of the free port, foreign trade zones are designed to increase the use of American labor and increase capital investment in the United States by allowing activity to occur in the United States prior to the application of US customs laws, thereby equalizing the customs treatment of the activity with similar activities occurring offshore.

Authorized by the Foreign-Trade Zones Act of 1934 (the Act),[1] foreign trade zones operate as public utilities pursuant to grants from the Foreign Trade Zones Board. Operations are governed by the Act and by regulations issued by the Department of Commerce[2] and the Department of Homeland Security, US Customs and Border Protection[3] (collectively, the Regulations). In addition, US Customs and Border Protection has published a Foreign-Trade Zones Manual that serves as a guide for all zone participants.

*Overview of economic benefits*

Both manufacturers and distributors can benefit from operating in a foreign trade zone. Because foreign trade zones are considered outside of customs territory, businesses may import product into a zone without paying customs duties. Duties on products destined for domestic destinations are deferred until products leave the zone, and products that are re-exported, either in original form or as part of a product made in a zone, are generally exempt from customs duties. With approval from the Foreign Trade Zones Board, a manufacturer may elect to pay duty on an imported component either at the duty rate applicable to the component or at the duty rate applicable to the finished product. In either case, US value added in the zone is not subject to duty. In an inverted tariff situation, one in which the duty rate on the finished product is lower than that on the imported component, manufacturing in a foreign trade zone results in a lower overall duty to the manufacturer.

Many businesses recognize logistics and merchandise processing fee (MPF) savings through the use of special foreign trade zone procedures for direct delivery and weekly entry. With direct delivery, an importer may bypass normal customs clearance procedures and move imported product directly into a foreign trade zone. Foreign trade zone users may also consolidate the reporting of all products shipped from the zone to domestic locations on a single weekly entry field with US Customs and Border Protection (Customs), and pay a single MPF for the week, capped at $485.

Businesses in some states recognize state and local tax savings. For example, state and local ad valorem tax on inventory is not applicable to foreign origin or foreign destination goods held in a foreign trade zone. Some state licensing requirements are not applicable to companies operating in foreign trade zones.

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[1] 19 U.S.C. §§ 81a-81u.
[2] 15 C.F.R. Part 400.
[3] 19 C.F.R. Part 146. Regulations relating to customs revenue functions are also regulations of the Department of the Treasury.

There are a variety of other savings that may be available to foreign trade zone users in specific situations. Benefits applicable to foreign trade zone users are described in more detail in Part II.

*Location*

The Act provides that foreign trade zones must be located in or adjacent to US ports of entry, and that each port of entry is entitled to at least one foreign trade zone. With 329 ports of entry in the United States, it is possible to locate a foreign trade zone virtually anywhere in the United States.

*Formation and operation*

The formation of a foreign trade zone is a multistep process. First, geographic approval for a foreign trade zone site must be obtained from the Foreign Trade Zones Board. Second, a business seeking to operate within a foreign trade zone must gain approval from the Foreign Trade Zones Board if there is production activity taking place at the zone site. Finally, a business wishing to use all or a portion of the foreign trade zone site must activate its operations with Customs.

Foreign trade zone operations involve four separate parties: the grantee, the operator, the user and the landowner. The grantee holds the grant from the Foreign Trade Zones Board and is ultimately responsible for zone operations. The grantee is quite often a public entity or quasi-public entity, or a non-profit corporation established specifically to hold the grant. The operator contracts with the grantee to run all or portions of the zone on a day-to-day basis, and is generally responsible for recordkeeping and dealing with Customs. The user is the business that owns the products in the zone, and benefits from using zone procedures. The landowner owns the property that has been designated as a foreign trade zone. In many instances, a single party serves multiple functions.

Obtaining the foreign trade zone designation is described in Part III. Conducting foreign trade zone operations is discussed in Part IV.

## II. Advantages of operating in foreign trade zones

*Duty deferral*

The universal benefit available to companies locating in a foreign trade zone is the deferral of customs duties on imported merchandise. Imported merchandise is subject to duty upon entry into the US customs territory, which normally coincides with the arrival of the merchandise in the United States. Because a zone is considered outside customs territory, however, merchandise that enters a zone is not dutiable until it leaves the zone and enters domestic commerce. As long as foreign goods remain in the zone, they remain free from duty. Simply maintaining imported product inventory in a foreign trade zone enhances the user's cash flow by delaying the time that duty must be paid.

*"Permanent deferral" cash flow benefit*

Importers can obtain a long-term cash flow savings advantage by "permanently" deferring the payment of duty for one inventory turn of merchandise held in a zone for as long as the zone remains operational. For example, consider a company that has an existing distribution facility that turns its inventory of imported merchandise four times each year. When the company first receives its foreign trade zone designation, it will have on hand a three-month supply of inventory upon which it has already paid customs duty at the time of import. For the first three months of foreign trade zone operations, new inventory will be imported into the zone without payment of duty. Items leaving the zone will be from the existing on-hand inventory that is already duty paid. As a result, no duty will be paid at all for that three-month period, either on products shipped into or out of the zone.

*No duty on re-exports*

As a corollary to the duty deferral rule, imported goods that are held in a zone and subsequently re-exported are not subject to a duty at all. Companies that import and re-export merchandise, either in its original form or as components of finished products produced in a zone, receive this benefit.

This general rule has been modified for manufactured products leaving US foreign trade zones for Canada and Mexico as part of the North American Free Trade Agreement (NAFTA) provisions seeking to equalize customs treatment on duty remission programs. Under NAFTA Article 303, a foreign component can be imported into a duty deferral program in a NAFTA country, such as a US foreign trade zone, for manufacturing into a finished product. If the finished product is subsequently exported to another NAFTA country, then the foreign component is subject to US duty to the extent the US duty exceeds the duty assessed on the completed product by the NAFTA trading partner. Absent this provision, it would be possible to incorporate a non-NAFTA component part (e.g., a Japanese origin part) into a NAFTA qualified finished good made in a US foreign trade zone, and export the finished product to Mexico or Canada without any duty being paid on the non-NAFTA (Japanese) component.

Some negotiated free trade agreements, such as the US-Australia Free Trade Agreement and the Central American Free Trade Agreement, do not have similar restrictions. Note, too, that there are techniques to mitigate the impact of free trade agreement restrictions where they exist.

Companies not located in a zone may obtain duty refunds with respect to re-exports by use of the duty drawback program. Zone use, however, is often more advantageous than drawback for the following reasons: (i) in the drawback program, an importer is initially required to pay duty upon entry and then apply for a refund of the duty later; in the foreign trade zone program, cash flow is enhanced because no duty is ever paid; (ii) under drawback, 99% of the duty paid may be recovered; in the foreign trade zone, 100% of the duty may be recovered as there is no 1% "fee" required of zone exports; and (iii) there are time restraints on claiming drawback, while there are no similar restraints with regard to zone exports. Additionally, while NAFTA rules prohibit manufacturing drawback for exports to Mexico or Canada, as noted above, zone procedures may sometimes be used to avoid these restrictions.

*Avoid inverted tariffs*

The tariff rate structure of the Harmonized Tariff Schedule of the United States, like that of most developed nations, generally assesses higher tariffs on finished products than on raw materials or component parts. This is not always the case, however. There are a number of instances in which a particular component part of a specific item is subject to a higher duty rate than would be applicable to the completed item. This situation is called an inverted tariff.

Manufacturers or assemblers that produce completed products that are subject to an inverted tariff may find substantial savings by operating in foreign trade zones. When imported goods are admitted into a foreign trade zone, the importer generally can choose which of two tariff rates will apply to the goods by electing the status of either (a) privileged foreign merchandise, which is subject to duty according to its condition and quantity at the time of admission into the zone, or (b) nonprivileged foreign merchandise, which is dutiable at the rate that applies at the time of its transfer from the zone into the customs territory of the United States. With regard to nonprivileged foreign merchandise, even though its dutiable value is determined by the condition and value upon its transfer from the zone, the value added in the United States is generally excluded from the calculation of the dutiable value. As a result, duty paid on nonprivileged foreign merchandise is essentially computed by multiplying the cost of the merchandise by the duty rate applicable to the merchandise in the condition in which it leaves the zone; i.e., the cost of the imported component part times the duty rate applicable to the finished product. Thus, the inverted tariff is entirely avoided by bringing high duty rate component parts into the zone on a nonprivileged basis and then manufacturing or assembling those parts into a finished product subject to a lower duty rate.

An example of an inverted tariff occurs with the assembly of cellular telephones. Completed cell phones are subject to duty free entry (a 0% duty rate) upon importation into the US. Cell phone batteries, however, are subject to duty, many at a rate of 3.4%. By establishing assembly operations in a zone, however, that manufacturer may bring the battery into the zone as nonprivileged foreign merchandise, assemble it into the cell phone and obtain duty-free treatment when the completed cell phone leaves the zone. The net result is a 3.4% duty rate savings on the battery, or a 17¢ savings per $5 battery.

Because the status of privileged foreign or nonprivileged foreign merchandise may be selected with respect to each imported item, a manufacturer located in the foreign trade zone can in effect elect the lower of the component part or completed product duty rate on an item-by-item basis.

*Production equipment*

Merchandise admitted into a foreign trade zone for use within the zone as production equipment, or parts thereof, is not subject to duty until the production equipment is completely assembled, installed, tested and used in actual production. The production equipment or parts thereof must be destined for use in zone production activity. Customs entry and duty payment occurs when the use of the merchandise as production equipment begins. Duty is assessed at the rate applicable to the completely assembled production equipment.

The preamble to the Commerce Department's foreign trade zone regulations references the Foreign Trade Zones Board's September 2010 memo in which the Board clarified its position on the production equipment benefit. The preamble states that there has been no change in the Foreign Trade Zones Board's fundamental findings as presented in the 2010 memo. The September 2010 memo notes that the production equipment provision is limited only to equipment for manufacturing operations and does not apply to equipment for distribution operations. The memo further indicates that companies can take advantage of the production equipment benefit while their manufacturing application is being reviewed by the Board. If the manufacturing application is denied, however, the company will be responsible for the full payment of duties on the imported components.

*Supply-chain and MPF benefits*

Foreign trade zone users can avoid customs clearance at ports of arrival, and report zone withdrawals weekly, which can speed the supply chain. Many businesses benefit from the flexibility of customs procedures applicable to goods moving into and out of zones. For example, the regulations provide for the direct delivery of merchandise into zones with the approval of the local Port Director of Customs. Direct delivery can quite often eliminate delays from processing back-up at the port of arrival and can be especially valuable to businesses utilizing a "just in time" inventory management system.

Weekly entry procedures, which allow a single entry document combining zone shipping activity over a week's period of time, are also allowed by regulation for manufacturing and distribution operations. Along with the administrative convenience, a single weekly entry is subject to the same cap of $485 on Customs' MPF as any other consumption entry. Companies that routinely exceed the amount of the single entry cap over the course of a week can save significant amounts on this fee. For example, an importer that typically files 20 customs entries per week, each subject to the $485 cap, would save $479,180 annually in MPF by using foreign trade zone weekly entry procedures (19 fewer entries per week x 52 weeks x $485). Associated customs broker fees may also be reduced, as fewer filings are necessary.

*State and local tax benefits*

The Act specifically prohibits state and local governments from assessing personal property tax on inventory that has either been imported into a foreign trade zone or is being held in a foreign trade zone for export. Added by the Trade and Tariff Act of 1984, this provision was specifically designed to clarify the non-taxability of inventory located in Texas zones. The federal exemption applies only to inventory, and not to equipment used in a manufacturing process or to other furniture or fixtures located in a zone. Some states have passed legislation providing for further tax benefits. Arizona, for example, taxes real property located in an activated foreign trade zone at a lower tax rate than other property, while Kentucky expands the personal property exemption to include all types of personal property, including furniture and fixtures.

*Obtain domestic identity*

Foreign components that are substantially transformed within a foreign trade zone lose their identity as foreign merchandise for customs marking purposes. This can be important from both a marking standpoint and in situations where non-US products are subject to use restrictions. For example, barges manufactured in the New Orleans foreign trade zone from foreign steel have been held to be made in the US, and are therefore eligible to lade and unlade cargo at points where lading is restricted exclusively to US vessels.

Another application of this rule is detailed in Customs Decision 79-41, in which Customs ruled that a chemical brought into a foreign trade zone from the People's Republic of China and substantially transformed into another version of the same chemical entered customs territory at the most favored nation Column 1 duty rate, despite the fact that at the time, PRC products were subject to the higher Column 2 rates of duty.

*Rectifying inadmissibility*

Goods not subject to importation into the United States may, in certain instances, be brought into a foreign trade zone where the deficiency may be rectified. For example, merchandise not properly labeled or packaged for the US market may be admitted to a zone and then relabeled or repacked in a foreign trade zone to conform to requirements of entry into domestic commerce.

*Scrap and waste*

Importers of goods that through storage or processing generate scrap or waste may also benefit from foreign trade zone status. Zone users access this benefit differently for privileged and nonprivileged inputs. Nonprivileged merchandise is dutiable in its condition when it leaves the zone, so, for example, duty is never paid on a defective nonprivileged item that is scrapped in the zone. Privileged foreign items are subject to an allowance for scrap and waste when used in a manufacturing process. Goodman Manufacturing, L.P. v. United States, 69 F.3d 505 (Fed. Cir. 1995) involves the value of foreign privileged steel used to make furnaces in a foreign trade zone. Upon entry of the furnaces into US customs territory, an allowance was given for the difference in value of the quantity of recoverable steel scrap prior to and after the manufacturing process. The dutiable value of the furnaces was, therefore, reduced by the difference in value between non-scrap and scrap steel times the amount of scrap steel. A similar benefit can be obtained when there is some other type of loss, shrinkage, evaporation or leakage in processing.

*Accelerate drawback*

A domestic manufacturer of a product with imported components may apply for drawback upon storing the finished product in a foreign trade zone pending export. Domestic manufacturers may also ship defective components to a foreign trade zone, where they may be destroyed, but treated as exported for purposes of drawback.

### *Maintaining preferential status*

A number of preferential trade programs require that product be directly shipped between the eligible countries in order for the preference to be applicable. For example, the EU-Mexico Free Trade Agreement conditions reduced duty or duty-free treatment on product moving directly between the EU and Mexico, without stopping in another country. Mexico has determined, however, that in some circumstances EU-origin product may move through a US foreign trade zone and maintain its preferential status. Similarly, goods stored in a US foreign trade zone generally remain eligible for the Generalized System of Preferences in the US.

### *Insurance*

Companies doing business in a foreign trade zone can often reduce their insurance costs. For insurance purposes, the insurable value of foreign goods in inventory includes the amount of duty paid. By storing foreign inventory in a zone, a business can reduce the insured value by the amount of duty that would have been paid and, accordingly, realize premium savings. Additional insurance savings may also be realized due to the extra security and fire protection measures generally taken in zones.

### *Quotas*

Following the concept that goods in a zone are outside of the customs territory of the United States, import quotas are generally not applicable to goods stored in foreign trade zones. If an importer of product subject to a quota finds that he has obtained over-quota merchandise, he may store the merchandise in a foreign trade zone rather than re-exporting the merchandise, and subsequently bring the merchandise into domestic commerce of the United States during the next quota period. Importers who come across bargain purchases of over-quota merchandise may similarly store the merchandise in a foreign trade zone until there is availability under the quota to bring the merchandise into domestic commerce.

## III. Obtaining foreign trade zone designation

*Foreign Trade Zones Board*

The Act establishes the Foreign Trade Zones Board, which is comprised of the Secretary of Commerce and the Secretary of the Treasury. Each of the secretaries has designated a department official to serve on the Committee of Alternates, which acts in place of the Foreign Trade Zones Board. Presently, the Committee of Alternates includes the Assistant Secretary of Commerce for Import Administration and the Deputy Assistant Secretary of the Treasury for Tax, Trade and Tariff Policy.

The daily operations of the Foreign Trade Zones Board are run by the Executive Secretary and the Foreign Trade Zones Board staff, who are Department of Commerce employees. Along with monitoring the day-to-day operation of the foreign trade zones program, the Executive Secretary is delegated some specific duties by the Regulations, including directing reviews and making recommendations or requests to establish foreign trade zones and subzones; making an annual report to Congress; approving the rates and rules applicable to each zone; and approving requests for minor modification of zone grants, for example, modifying zone boundaries.

The Foreign Trade Zones Board staff is presently organized to include regional representatives. The representatives' role is to better meet grantees' needs and improve the functioning of the foreign trade zone program. There are four regional representatives covering the Eastern, Great Lakes, Central and Western United States. A list of the representatives is available at the Foreign Trade Zones Board's website, *http://ia.ita.doc.gov/ftzpage/*.

*New Commerce regulations offer simplified procedures*

The Commerce Department recently issued new foreign trade zone regulations, which became effective April 30, 2012. This revision represents the first time the foreign trade zone regulations have been updated since 1991. The goal of the new regulations is to simplify and modernize foreign trade zone procedures. There are several significant changes, including the introduction of the term "production," which essentially combines the definitions of "manufacturing" and "processing" from the 1991 regulations. Other key changes include a simplified procedure for requesting production authority, an abbreviated subzone application and approval process and shortened processing times for several zone related applications.

*Obtaining geographic designation as a foreign trade zone — generally*

An application to establish a foreign trade zone may be done under the traditional site framework (TSF) or the Alternative Site Framework (ASF). Under the TSF, grantees typically request designation for a zone site/s that can serve multiple businesses wishing to use the zone, traditionally called "general purpose zone sites". An industrial park, for example, has traditionally been designated under the TSF approach.

The ASF is a voluntary program that allows grantees to designate and manage their foreign trade zone with greater flexibility. Under the ASF, grantees seek expedited approval for new foreign trade zone projects within a pre-designated

"Service Area," rather than limiting the project location to the strict boundaries under the TSF.

Geographical designation can also be obtained for a special purpose subzone. A subzone is established as an adjunct to an existing foreign trade zone (under both the TSF and ASF structures). A subzone consists of a site (or group of sites) established for a specific use.

*Obtaining geographic designation as a foreign trade zone — traditional site framework*

The Foreign Trade Zones Board may issue a general purpose foreign trade zone grant to an applicant upon determination that there is a need for zone services and a workable plan that includes suitable facilities and financing. As a prerequisite to making an application for a general purpose zone, an applicant must obtain enabling legislation from its state legislature. Most states have enacted "blanket" enabling statutes, allowing specific types of entities (e.g., a corporation organized specifically to establish a zone) to make application to the Foreign Trade Zones Board without being required to obtain further approval of the legislature.

The application must meet the requirements of the Act and the Regulations. An application may be made by a public corporation (i.e., a state or a political subdivision thereof, a municipality, a state public agency or a corporate municipal instrumentality of one or more states), or by a private corporation organized specifically to establish a zone. An application by a public corporation is given preference for approval by the Foreign Trade Zones Board.

Although the first formal step in establishing a general purpose foreign trade zone is the application to the Foreign Trade Zones Board, a substantial amount of preliminary work is generally necessary. An economic cost/benefit analysis is usually performed to determine the feasibility of the project. For new general purpose zone projects, choosing the entity to serve as grantee is also important, as is site planning and evaluation of financing alternatives. Once the preliminary studies are complete, the application process begins.

An application for a general purpose zone focuses on the need for zone services and public benefit to the community surrounding the proposed foreign trade zone. The Regulations require that an application for a general purpose zone contain a variety of information and data, including proof of authority to make the application, a preliminary estimate of the cost of the project, plans for operating and financing the undertaking, and an economic survey of anticipated benefits.

An application to establish a zone will normally be processed within 10 months.

*Obtaining geographic designation as a foreign trade zone — alternative site framework*

The ASF can be adopted to establish a new zone or to reorganize an existing zone. The ASF allows grantees expedited approval for new foreign trade zone projects within a pre-designated Service Area. A Service Area is typically defined by counties, and the governing bodies of the included counties must consent to inclusion in the Service Area. Within the Service Area, sites such as industrial parks that serve multiple users can be designated "magnet sites." ASF also provides for a "usage-driven site." Under this concept, a site dedicated to a specific company can be designated as a foreign trade zone site with an abbreviated application, which may be approved in 30 days. The designation is tied to a specific company and is limited to the space needed by the company.

Usage-driven sites can be a much faster and more cost-effective way to obtain a zone designation than a traditional general purpose or subzone application.

Magnet sites must be activated within five years or the designation will sunset. Usage-driven sites have three years to be activated and show the admission of foreign-status merchandise or the site will sunset. Companies seeking production authority still need to follow the production approval application process.

An ASF applicant to establish a new zone will normally be processed in 10 months and an ASF application to reorganize an existing zone will normally be processed in 7 ½ months.

*Obtaining geographic designation as a foreign trade zone — special purpose subzones*

An application to obtain subzone status is made by the grantee of a foreign trade zone, and consequently does not require separate enabling legislation. A subzone may be applied for under the TSF or ASF. Under either scenario, the application process has been substantially streamlined under the new Commerce regulations. Under the ASF, a subzone within the designated Service Area may be established using the minor boundary modification procedure.

Under the TSF or if the proposed subzone is outside of the ASF's Service Area, an application for a subzone must be submitted. The application for a subzone is now much simpler than it was under the old Commerce regulations. The application no longer requires the applicant to state how the subzone will provide a significant public benefit or why the operation cannot be accommodated within the general purpose zone. Basic information that is now required includes the name of the operator/user for which subzone designation is sought, the nature of the activity at the proposed subzone site(s) and location information.

In evaluating subzones (as well as expansion and other modification of zone applications), the Board considers the need for zone services, the suitability of each site, the specific need and justification for each proposed site, the extent of state and local government support and the views of persons likely to be materially affected by the proposed zone activity.

A subzone application will normally be processed between 3 to 5 months (versus 6 or more months under the old regulations). It will be 5 months if the application is not subject to the general purpose zone's activation limit. If the application is subject to the activation limit, then the time period is 3 months for approval. A request for subzone designation for a site(s) located within an ASF Service area can be processed in 30 days.

*Obtaining production authority for a foreign trade zone*

Production activities that will take place within a designated foreign trade zone area require prior approval from the Foreign Trade Zones Board. Under the Commerce regulations, "production" means "activity involving the substantial transformation of a foreign article resulting in a new and different article having a different name, character, and use, or activity involving a change in the condition of the article which results in a change in the customs classification of the article or in its eligibility for entry for consumption." This definition of "production" is a combination of the definitions of "manufacturing" and "processing" under the old Commerce regulations, which provided for two separate types of applications for authority. Under the new Commerce regulations, the application process has been streamlined, with manufacturing and processing being consolidated under one type of authority — production authority.

The procedure has been further simplified with the introduction of the production notification step. The first step in seeking approval of production authority is filing a production notification with the Board. The production notification is required to contain the following basic information: (1) the identity of the user and its location; (2) the materials, components and finished products associated with the proposed activity, including 6-digit HTSUS numbers; and (3) information about whether any material or component is subject to a trade-related measure or proceeding, such as antidumping or countervailing duties.  Approval of production notification normally takes 120 days.

In some circumstances, upon reviewing the production notification, the Board may determine that further review is necessary, and thus will require the applicant to file a detailed application for production authority.  Production authority applications will normally be processed in 12 months, but it could be longer for applications involving complex or controversial issues.

A production application must contain an explanation of the anticipated economic effects of approving the activity, in addition to much more extensive detail about the proposed activity and the industry. The production application is reviewed based on specified criteria to determine whether the particular activity is in the public interest. Evaluation of the production activity involves two phases of consideration: (1) whether the activity is consistent with trade policy and programs; and (2) whether its net economic effect is positive.

The review of consistency with trade policy and programs involves consideration of three threshold factors: (1) whether the activity is inconsistent with US trade and tariff law or Executive Branch policy; (2) whether approval of the activity would seriously prejudice US tariff and trade negotiations or other programs; and (3) if the activity involves articles subject to quotas or inverted tariffs, whether the ability to use zone procedures would be the direct and sole impetus for the import under consideration. If the activity passes the threshold review (that is, if all three questions are answered in the negative), it is considered consistent with trade policy and is evaluated for its net economic effect.

The net economic effect evaluation involves consideration of a variety of factors, including the overall effect on employment, the impact on exports and re-exports, the retention or creation of production activity, the extent of value-added activity, the overall effect on imports of relevant products, the extent and nature of foreign competition and relevant products, the impact on related domestic industry, and any other information relating to public interest and the net economic impact of the activity. In the economic assessment, the contributory effect of zone savings may be considered as an incremental part of cost effectiveness programs adopted by companies seeking to improve their international competitiveness.

The Board may choose to approve production activity with restrictions adopted to protect the public interest, health or safety. For example, restrictions sometimes occur when imported components used in a zone process are competitive with similar products from protected domestic industries. In that instance, the grant may be restricted so that zone procedures do not result in decreased duties on those components.

*Application for expansion or other modification to zone*

Zone grantees may apply to the Board to expand or otherwise modify a zone. The Executive Secretary will determine whether a proposed modification is minor or major. A minor modification will generally be approved by the Executive Secretary within 30 days of the request. Designation of a subzone or usage-driven site within an ASF Service Area and a small modification to the boundary of a general purpose zone or subzone would generally be considered minor modifications. If the Executive Secretary determines the proposed modification is major, an extensive application, similar to an application for a new general purpose zone, will be required. The timeframe for approval of a major modification is the same as for a new general purpose zone — 10 months from docketing.

*Application evaluation and review procedures*

The evaluation and review procedures for applications to establish a foreign trade zone, production authority, major modification to a zone and a subzone are detailed in the Regulations and summarized below.

After a pre-docketing copy of the application is sent to the Foreign Trade Zones Board by the grantee (or the applicant in certain cases), the staff makes a determination as to whether all of the data required by the Regulations is contained in the application. If the application is deficient, the Executive Secretary of the Foreign Trade Zones Board will notify the applicant within 30 days of receipt of the pre-docketing copy, giving the applicant 30 days to submit a corrected application. Once the application is determined to be sufficient, the Executive Secretary will notify the applicant within 15 days to request that the applicant submit an original and the required number of copies for docketing. Within 15 days of receipt of the original and required copies of the application, the Executive Secretary will formally docket the application, assign a docket number and notify the applicant.

Public notice of the filing is given in the Federal Register. The notice contains the name of the applicant, a general description of the proposal and an invitation for public comment. Additionally, the applicant is required to publish a public notice of the filing of the application in a local newspaper at least 15 days prior to the close of the public comment period.

For applications to establish or expand a zone or production authority, the public comment period normally lasts 60 days from the date of notice in the Federal Register and is followed by a 15-day rebuttal period. For subzone applications, the comment period normally lasts 40 days from the date of the notice.

No more than 30 days from the beginning of the public comment period, a directly affected party showing good cause may request a hearing. When a hearing is requested, the Assistant Secretary of Commerce for Import Administration determines whether there is a need for the hearing. If a hearing is held, all participants will have the opportunity to present their views. If a hearing is held, the comment period will not close before 15 days after the date of the hearing.

Review of an application to establish or modify a zone, obtain production authority, or designate a subzone is made by an examiner designated by the Executive Secretary, generally a Foreign Trade Zones Board staff member, and may be reviewed, at the request of the examiner, by additional Department of

Commerce staff members. The application is also reviewed by Customs. Taking into account input from the reviews as well as any public comments received, the examiner submits a report with recommendations to the Executive Secretary. If the report is unfavorable to the applicant, it is considered preliminary and the applicant is given an opportunity to respond. If there is new evidence submitted then notice may be published in the Federal Register and the public given the opportunity to respond.

Once the report is finalized, the Executive Secretary then submits the examiner's report with a recommendation to Customs headquarters and the Treasury Board for review and action. Once the decision of Treasury is received, the Commerce Department completes the decision process and publishes the decision in the Federal Register.

# IV. Operating in foreign trade zones

*Customs approval for foreign trade zone operations*

A company located within a geographic area designated as a zone must "activate" its zone space with Customs prior to commencing zone operations. The activation procedure is designed to ensure that Customs has sufficient information to monitor and audit zone operations. The materials required in an activation package are specified in the Regulations. The actual level of review of the materials prior to activation, however, varies from port to port. Generally, the Port Director reviews the physical security of the site, the foreign trade zone inventory control procedures that have been established, the background of the personnel who will have access to and could change the foreign trade zone inventory and recordkeeping, bonding and other documentary requirements of Customs. Upon the approval of the Port Director, the zone space is activated.

*Supervision of operations*

Zone operations are under the supervision of Customs. The Port Director is responsible for the enforcement of the requirements of the Act and Regulations as well as requirements for such matters as zone forms, inventory control systems, cargo security standards, and physical security of each zone as directed and determined by Customs. The Port Director assigns Customs officers as may be necessary to maintain appropriate Customs supervision of merchandise and records in a zone. The Port Director not only represents Customs, but is also the local representative of the Foreign Trade Zones Board for each zone at or adjacent to the Port. In this capacity, the Port Director interfaces with the Foreign Trade Zones Board staff on operational issues.

Since zones are to be operated according to public utility principles, the rates and charges for space, facilities and services within a zone must be fair and reasonable, and the grantee is required to afford uniform treatment to all users. Any user or potential user of a zone may submit a complaint to the Executive Secretary of the Foreign Trade Zones Board, who must make a determination as to whether the grantee is operating the zone as a public utility and whether its rates and charges are fair and reasonable. In addition, the Executive Secretary or the Foreign Trade Zones Board may initiate a review for cause.

*Inventory control and recordkeeping*

A major component of obtaining activation approval is having an inventory control and recordkeeping system in place. Proper inventory controls allow for effective foreign trade zone utilization and provide Customs the audit trail to ensure that duties have been collected on those items that leave the zone for domestic destinations. A zone operator's inventory control and recordkeeping system is described in a procedures manual filed with the local Customs Port Director as part of the activation process, which facilitates both spot-checks and audits.

Customs has preapproved two types of inventory accounting methods: specific identification and first-in, first-out. Other methods may be approved by Customs headquarters. Specific regulations detail the inventory control requirements for foreign trade zone oil refineries based on producibility, an industry standard method for attributing feedstocks to refined product. The Customs Foreign

Trade Zones Manual provides a detailed description of zone inventory and recordkeeping requirements.

*Customs administration audit-inspection system*

Customs utilizes an audit-inspection system whereby the responsibilities of direct supervision, recordkeeping, and merchandise status, movement and security are placed on the bonded zone operator.

The audit-inspection system is based upon six procedures: (1) the determination by Customs of the identity and nature of merchandise prior to or upon admission to the zone to determine the initial responsibility of the operator; (2) the issuance of a permit to the operator by Customs for admission, transfer and processing of merchandise; (3) the assumption by the operator of responsibility for the merchandise, recordkeeping and physical supervision within the zone; (4) the performance of spot-checks and audits by Customs to determine if the operator is properly supervising and maintaining records of the merchandise; (5) the assessment by Customs of liquidated damages for violations in an amount sufficient to ensure proper performance by the operator; and (6) the temporary suspension by Customs of zone operations that do not comply with the rules and regulations of Customs. These procedures, along with other safeguards and supervision, enable Customs to oversee, manage and regulate the operation of foreign trade zones without the necessity of having a Customs officer physically present at all zone sites.

*Zone operator*

The zone operator is responsible for the direct supervision, recordkeeping, merchandise status, movement and security within the foreign trade zone. An operator can be an entity or individual, but must have the prior approval of the Port Director of Customs and must post a bond to ensure the proper performance of all required activities. The amount of the bond is typically negotiated between the operator and the Port Director. The operator's responsibilities and duties are generally set out in an operator's agreement between the operator and the grantee. Although the grantee has the responsibility to manage the foreign trade zone, the grantee's grant of authority does not make the grantee liable for violations by the operator, unless the grantee undertakes detailed oversight/direction of its operators/users.

The operator is expected to exercise the same standard of care as would a prudent manager of a storage, manipulation or manufacturing facility. The operator must give any Customs officer access to the zone and provide all records and other materials as requested by the Customs officer within a reasonable amount of time. The operator is responsible for the safekeeping of merchandise and records concerning merchandise admitted to a zone. The operator may delegate this responsibility to zone users to store, safeguard, and otherwise maintain or handle the goods and the inventory records pertaining to them. The operator, however, remains liable to Customs in the event the zone user fails to operate in an appropriate manner. The operator must maintain the inventory control and recordkeeping system in accordance with applicable regulations retain all records required to be maintained pertaining to zone merchandise for a period of five years after the merchandise is removed from the zone, and protect proprietary information in its custody from unauthorized disclosure. The operator must maintain the zone and establish procedures adequate to ensure the security of merchandise located in the zone in accordance with applicable Customs security standards and specifications. The operator must store and handle merchandise in the zone in a safe and sanitary manner to minimize damage to the merchandise, avoid hazards to persons, and meet applicable local, state and federal requirements for specific types of goods.

Many grantees contract with a separate entity to act as operator for all, or portions of, the zone on a day-to-day basis. Zones typically allow multiple operators. Subzone users and general purpose zone users that have their own facilities frequently serve as their own operators, or contract with third-party operators that differ from user to user. If the zone user is not the zone operator, but is the importer of record for products removed from the zone and delivered to a domestic destination, it has ultimate responsibility for the accuracy of its entry filings and could face potential fines and penalties if those filings are inaccurate, separate and apart from those faced by the zone operator.

*Grantee*

The new Commerce regulations add specific provisions related to the concepts of public utility and uniform treatment. The Act requires that each zone "be operated as a public utility, and all rates and charges for all services or privileges within the zone shall be fair and reasonable." The new regulations provide that fees charged by the grantee must be based on costs incurred by the grantee and be directly related to the service provided by the grantee. With respect to uniform treatment, the Act requires that each zone "grantee shall afford to all who may apply for the use of the zone and its facilities and appurtenances uniform treatment under like conditions." The new regulations specifically provide for uniform treatment in the evaluation of proposals and that the grantee must have justification where treatment is different.

## V. Customs treatment of merchandise in foreign trade zones

*Admission of merchandise into a zone*

Customs regulations provide that merchandise of every description may be admitted into a zone unless prohibited by law. However, even prohibited merchandise may be temporarily admitted pending a final determination of its status.

In order to admit imported merchandise to a zone, an electronic Customs form e214 or paper Customs form 214 must be filed with, and a permit must be obtained from, the Port Director. Quite often, direct delivery procedures are established so that a separate permit is not required with each admission. Domestic merchandise may be admitted to a zone without an application or permit.

*Status of merchandise in a zone*

All merchandise located in a zone (except merchandise, which is unladen in a zone for immediate delivery into customs territory) assumes one of four different status designations, each of which receives different customs treatment. The designations are: privileged foreign merchandise, nonprivileged foreign merchandise, domestic merchandise and zone-restricted merchandise.

**Privileged foreign merchandise:** Privileged foreign merchandise is subject to appraisement and tariff classification according to its condition and quantity at the time at which the operator makes application for privileged foreign status. As a result, when privileged foreign merchandise is entered into customs territory, duty is calculated using the value and rate established when the merchandise was designated as privileged foreign. An application requesting this status may be made at any time provided that the merchandise has not been manipulated or manufactured in such a manner so as to alter its tariff classification. Once elected, privileged status cannot be abandoned, except in the case of recoverable waste. If the merchandise is exported or properly withdrawn for supplies, equipment or repair material of vessels or aircraft, no duties or taxes are paid.

**Nonprivileged foreign merchandise**: Nonprivileged foreign merchandise is dutiable at the rate applicable at the time of its transfer from the zone into customs territory. Merchandise is nonprivileged foreign if it is: (1) foreign merchandise properly in a zone that does not have privileged or zone-restricted status; (2) waste recovered from any manipulation or manufacture of privileged foreign merchandise within a zone; or (3) domestic merchandise in a zone that has lost its identity as such. Any domestic merchandise will be considered to have lost its identity if Customs determines that it cannot be identified positively as domestic merchandise on the basis of an examination of the merchandise or consideration of any proof that may be submitted. Even though the dutiable value of nonprivileged foreign merchandise is determined by the condition and value of the merchandise upon its transfer from a zone, the following items are excluded from the calculation of its dutiable value: (1) the cost of processing in the zone (including labor cost); (2) the general expenses and profit attributable to zone operations; (3) expenses incurred in the zone that are incidental to placing the merchandise packed ready for transfer to the customs territory; and (4) freight, insurance and similar costs incurred after the merchandise is packed ready for transfer to the customs territory. As a result, the duty paid on nonprivileged foreign merchandise is essentially computed by multiplying the cost of the merchandise by the duty rate applicable to the merchandise in the condition in which it leaves the zone; e.g., the cost of a component times the duty rate applicable to the finished product.

**Domestic merchandise:** Domestic status may be granted to merchandise: (1) grown, produced or manufactured in the United States on which all internal revenue taxes, if applicable, have been paid; (2) previously imported and on which duty and tax has been paid; or (3) previously entered free of duty and tax. No application or permit is required for the admission of domestic merchandise to a zone except upon order by the Commissioner of Customs. Further, no application or permit is required for the manipulation, manufacture, exhibition, destruction or transfer of domestic merchandise except: (1) where it is mixed or combined with merchandise having another zone status; or (2) upon order of the Commissioner of Customs. Domestic merchandise may be returned to customs territory free of quotas, duty or tax.

**Zone-restricted merchandise:** This status applies to merchandise that is taken into a zone for the sole purpose of exportation, destruction (except destruction of distilled spirits, wines and fermented malt liquors) or storage. Zone-restricted merchandise may not be removed to customs territory for domestic consumption unless the Foreign Trade Zones Board (or in some instances the Executive Secretary) finds the return to be in the public interest. An application for zone-restricted status may be made at any time the merchandise is located in the zone, but zone-restricted status cannot be abandoned once it is granted. Zone-restricted merchandise may be considered “exported” for the purpose of any Customs law, including drawback and warehousing, if all applicable Customs requirements for actual export are met.

*Permitted activities in the zone*

Subject to a few limited exceptions, any foreign or domestic merchandise may be brought into a zone to be stored, sold, exhibited, broken up, repacked, assembled, distributed, sorted, graded, cleaned, mixed with foreign or domestic merchandise, or otherwise manipulated or manufactured. Retail trade is, with certain limited exceptions, prohibited in foreign trade zones.

In order to manipulate, manufacture, exhibit or destroy merchandise within a zone, permission must be obtained from the Port Director of Customs. Customs has established special guidelines and procedures related to specific types of merchandise and particular procedures in order to protect the revenue of the United States.

An application to manipulate, manufacture, exhibit or destroy merchandise within a zone must be made on Customs form 216 by the operator of the zone. A blanket application, a certificate to continue for a limited period of time the manipulation, manufacture, exhibition or destruction of merchandise in a zone as opposed to making a separate application for each part of an ongoing activity, is generally available. A denial of an application (or blanket application) by the Port Director is appealable to the Foreign Trade Zones Board. If any revenue-protection considerations are involved, the Board must adhere to any determinations made by the Secretary of the Treasury.

*Disposition and removal of merchandise*

Customs regulations contain very specific and detailed requirements regarding the disposition or removal of merchandise from a zone. Careful compliance with these regulations, as well as very detailed planning, is necessary to maximize the available benefits. Examples of disposition and removal include direct export, withdrawal as equipment, supplies or repair material for vessels or aircraft, destruction of merchandise either inside or outside of the zone, the transfer of merchandise from one zone to another or the entry of the merchandise into the customs territory. Further, merchandise may be treated as removed from a zone even though it remains physically present within the zone to take advantage of favorable tariff rates or quota restrictions. With careful planning and adequate documentation, very favorable results can be achieved through the variety of disposition and removal techniques that are available.

## VI. Laws applicable in foreign trade zones

Although a foreign trade zone is created by grant from the federal government, the foreign trade zone is not an enclave immune from federal or state law. As a general rule, federal law not inconsistent with the specific terms of the Act has been held applicable to foreign trade zone operations. For example, federal law provisions applicable to trademark infringements have been held to apply to acts occurring within a foreign trade zone. A.T. Cross Company v. Sunil Trading Corp., 467 F.Supp. 47 (S.D. NY 1979).

State and local laws similarly have general applicability; however, state and local laws have been held to be inapplicable to foreign trade zone operations when the laws interfere with the purpose of the Act, foreign commerce. In 3M Healthcare, Ltd. v. Grant, 908 F.2d 918 (11th Cir. 1990), the 11th Circuit found that the Foreign Trade Zones Act preempted application of a licensing requirement of the Florida Drug and Cosmetic Act to a company warehousing cosmetics in the Port Everglades Foreign Trade Zone. The facts of the 3M case involve cosmetics ineligible for admission into the United States under federal law, which were warehoused in the zone for subsequent shipment to the Caribbean and South America. The court found that Florida's licensing requirements did not apply to these particular cosmetics. The case specifically leaves open the issue of whether the State of Florida may legitimately exercise its police power with regard to goods stored in a foreign trade zone that are ultimately destined for domestic consumption. Similarly, in During v. Valente, 46 N.Y.S.2nd 385, 267 App. Div. 383 (1944), a New York court held that New York state liquor sales permits are not required of a vendor making sales in a foreign trade zone, reasoning that liquor license regulations are an undue burden on foreign commerce. Where there is no interference with foreign commerce, state law applies. No interference with commerce was found, for example, with state court jurisdiction for a wrongful death action for a death occurring within a foreign trade zone. Fountain v. New Orleans Public Service, Inc., 387 F.2d 343 (5th Cir. 1967), or with application of a California excise tax applied to imported, duty-paid cigarettes destined for the US market and stored in a foreign trade zone, United States v. Intrigue Trading Inc., 448 F.3d 1168 (9th Cir. 2006).

In 1984, Congress added Section 15(e) to the Act to conclusively pre-empt state and local ad valorem taxation of merchandise in foreign commerce that is located in a foreign trade zone. The legislative history indicates that the provision was added to remedy a problem faced by Texas foreign trade zones, which were threatened with ad valorem inventory tax pursuant to Texas constitutional provisions requiring that all property be placed on the tax rolls. Section 15(e) preempts state and local governments from assessing ad valorem tax on foreign origin goods and domestic goods destined for export that are located in a foreign trade zone. The exemption applies only to inventory and not to equipment used in the manufacturing process or to furniture or fixtures located in the zone. A federal court decision upheld the constitutionality of the exemption. Deer Park Independent School District, et al. v. Harris County Appraisal District, et al., 132 F.3d 1095 (5th Cir. 1998), cert. denied 118 S.Ct. 2343 (1998).

## VII. Conclusion

Designed specifically to "level the playing field," foreign trade zones can help US business operations grow and compete cost-effectively with foreign operations. The April 30, 2012 regulations reflect the Foreign Trade Zones Board's goal to streamline the application process, making the process less time-consuming and more affordable. With careful planning and assistance from qualified, experienced professionals, significant savings can be achieved; helping US businesses expand domestic activity and exports.

EY is a national leader in advising on foreign trade zone matters. Services include strategic planning for tax and duty savings, establishing foreign trade zones, developing foreign trade zone inventory control systems, outsourcing foreign trade zone operations, and providing advice to foreign trade zone users, grantees, operators and landowners.

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