

2013

U.S. Foreign Trade Zones of the United States, Free-Trade Zones of the World, and their Impact on the Economy

Susan Tiefenbrun

Follow this and additional works at: <http://scholarlycommons.law.hofstra.edu/jibl>



Part of the [Law Commons](#)

Recommended Citation

Tiefenbrun, Susan (2013) "U.S. Foreign Trade Zones of the United States, Free-Trade Zones of the World, and their Impact on the Economy," *Journal of International Business and Law*: Vol. 12: Iss. 2, Article 11.

Available at: <http://scholarlycommons.law.hofstra.edu/jibl/vol12/iss2/11>

This Legal & Business Article is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in *Journal of International Business and Law* by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD, AND THEIR IMPACT ON THE U.S. ECONOMY

*Susan Tiefenbrun**

I. INTRODUCTION.....	151
A. Background of FTZs.	151
B. What are FTZs and SEZs?	152
C. Stereotypes and Types of FTZs.	153
D. Export-increasing Function of FTZs.	153
E. Objectives of FTZs.	154
F. Global Proliferation of FTZs.	154
G. Success and Failure of FTZs.	155
1. Why Does a FTZ Fail?	155
2. What Accounts for the Success of a FTZ?	156
H. Threats to FTZ Expansion.	157
I. Names of Zones.....	158
1. Free trade zone	158
2. Free port	158
3. Transit Zone	158
4. Free Perimeter.....	158
5. Export Processing Zone (EPZ).....	158
6. Single Factory EPZ.....	158
7. Enterprise zone.....	159
8. Specialized zone.....	159
J. FTZ Benefits to Importers and Exporters.	159
K. Statistics on FTZs.....	159
L. More About the Terms Related to Free Trade Zones.	160
M. History of Free Trade Zones.	166
N. Free Trade Zones vs. Free Trade Areas.....	166
II. FOREIGN TRADE ZONES IN THE U.S.....	167
III. FREE TRADE ZONES OF THE WORLD.....	171
A. Economic Performance and Impact of Free Trade Zones	171
B. Specific Free Trade Zones of the World.....	174
1. China.....	174
2. Russia	175
3. North Korea	176
4. Japan.....	177
5. Vietnam.....	177
6. Cambodia.....	178
7. Cyprus	178
8. Africa.....	178
9. Kenya.....	179
10. Gambia	179
11. Burundi.....	180

* Professor of International Law

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

12. Algeria	180
13. Middle East.....	180
14. Central America	180
IV. FREE TRADE ZONES AND THEIR SERVICES	180
V. FREE TRADE ZONES AND THE EUROPEAN UNION	182
VI. MAJOR BUSINESS BENEFITS OF FREE TRADE ZONES	182
A. No Customs Formalities	182
B. Improved Cash Flow	183
C. Owner Access to Merchandise	183
D. Showroom Space Available	183
E. Accounting Advantages.....	184
F. Reduced Insurance and Duty Costs.....	184
G. Assembly of Domestic with Foreign Goods.....	184
H. Ideal Manufacture Location of Goods	184
I. Processing or Manipulation of Goods	185
J. Packing, Repacking, and Labeling.....	185
K. Easy to Discard Goods	186
L. Wide Variety of Products Handled	186
VII. SOME PRACTICAL ASPECTS OF USING A FOREIGN TRADE ZONE IN THE UNITED STATES OR A FREE TRADE ZONE IN THE WORLD	186
A. Protection Against Theft	187
B. Helps Trade Balance	188
C. Typical Processing Transaction	189
D. Tax Treatment Favorable for Zone Users.....	189
E. Tax Treatment: Domestic Users and Foreign Exporters into USA FTZs Should Avoid “Permanent Establishments” and “Being Effectively Connected”	190
VIII. CUSTOMS-RELATED ISSUES FOR USERS OF FREE TRADE ZONES	191
IX. AMENDMENTS PROPOSED BY U.S. FOREIGN TRADE ZONES BOARD TO FACILITATE INTERNATIONAL TRADE	192
X. ENTERPRISE ZONES.....	196
A. Enterprise Zones, Empowerment Zones, and Their Public Service to the U.S. Economy	196
B. Enterprise Zones in the World and Their Economic Benefits.....	196
XI. APPLICATION OF NATIONAL LAWS TO FREE TRADE ZONES	199
XII. TAX BENEFITS OF FOREIGN TRADE ZONES IN THE U.S.	199
A. Corporation Income Tax and Payment.....	199
B. Corporation Alternative Minimum Tax.....	200
C. Capital Gains.....	201
D. FOREX (foreign exchange)	201
E. Branch Profit Tax for Foreign Corporations	201
F. Payment to Non-residents.....	201
G. State Level Tax.....	202
H. State Level Tax Base	202
I. Social Security Taxes	203
J. Income as to U.S. Non-residents.....	204
XIII. U.S. GOVERNMENT GUARANTEES TO USERS OF FOREIGN TRADE ZONES	205
XIV. SPECIAL INDUCEMENTS OFFERED BY FTZS.....	205
A. Federal Incentives	205
B. Foreign Service Corporation.....	207
XV. REBATES, BONDED WAREHOUSES, AND FREE TRADE ZONES.....	208

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

XVI. CUSTOMS PRIVILEGES IN FREE TRADE ZONES, PRIVILEGED AND NON-PRIVILEGED STATUS OF GOODS, CUSTOMS FORMS AND PROCEDURES.....	208
XVII. SPECIFIC FUNCTIONS OF THE FREE TRADE ZONES	211
XVIII. BANKING EXCHANGE AND CREDIT STATUS OF THE FTZ	211
XIX. FTZs ARE A REGULATED PUBLIC SERVICE UTILITY	212
XX. CONCLUSION.....	212
A. Are U.S. Foreign Trade Zones Increasing U.S. Exports and Employment?	212
B. Disadvantages of U.S. Foreign Trade Zones and Free Trade Zones of the World. 219	
C. Advantages of U.S. Foreign Trade Zones and Free Trade Zones of the World	221

I. INTRODUCTION

A. Background of FTZs

Today more than one hundred thirty-five countries including the United States operate tax-free trade zones (FTZs).¹ There are more than three thousand five hundred of these zones and subzones all over the world.² Free trade zones actually began early in the time of the Phoenicians who created the concept of the international free trade zone.³ The Romans later developed FTZs for the purpose of economic and political domination.⁴ Citywide free zones and *entrepôts* “that [guarantee] free storage and exchange along secure trade routes – such as Gibraltar, Hamburg, and Singapore – have been operating for centuries.”⁵ The free trade zones in Gibraltar and Singapore were in place as early as 1704 and 1819, respectively.⁶ “The first modern industrial free zone was established in Shannon, Ireland, in 1959.”⁷ The developing countries began to focus on free trade zones after the United Nations adopted an Economic and Social Resolution at the 1506th plenary meeting on August 4, 1967. This resolution suggested that one of the fundamental means of export expansion was the improvement

¹ See generally SUSAN TIEFENBRUN, TAX-FREE TRADE ZONES OF THE WORLD AND IN THE UNITED STATES (2012). I would like to give special thanks to my law student, Matthew Odgers, for his able assistance in the research for this article, which is an updated and fully revised version of the Introduction to my book TAX-FREE TRADE ZONES OF THE WORLD AND IN THE UNITED STATES. The late Walter H. Diamond, who worked extensively on free trade zones of the world, was a bona fide expert in the field, and he asked me to write this book, which provides a detailed description of all the U.S. foreign trade zones. I considered that invitation a great honor. Portions of this article are reprinted from 1 WALTER H. DIAMOND & DOROTHY B. DIAMOND, TAX-FREE TRADE ZONES OF THE WORLD (Matthew Bender & Co., Inc., 1995) [hereinafter DIAMOND & DIAMOND] with permission from Matthew Bender & Company, Inc. All rights reserved.

² WORLD BANK, SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS 5 (Thomas Farole & Gokhan Akinci, eds., 2011), available at <http://documents.worldbank.org/curated/en/2011/01/14813550/special-economic-zones-progress-emerging-challenges-future-directions> [hereinafter WB 2011 Report].

³ See Walter H. Diamond, *Tax-Free Trade Zones Aid Both Exporters and Importers*, THE AMERICAN BANKER, Oct. 20, 1980.

⁴ *Id.*

⁵ WB 2011 Report, *supra* note 2, at 3.

⁶ See FIAS, SPECIAL ECONOMIC ZONES: PERFORMANCE, LESSONS LEARNED, AND IMPLICATIONS FOR ZONE DEVELOPMENT 2 (April 2008), available at <https://www.wbginvestmentclimate.org/toolkits/investment-generation-toolkit/upload/SEZ-Report-April-2008.pdf> [hereinafter WB 2008 Report].

⁷ See WB 2011 Report, *supra* note 2, at 3.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

of ports, Customs, and trade zone facilities in developing countries. Tax-free trade zone programs began to develop in the 1970s and continued to proliferate.⁸ Developing countries increased their number of FTZs because they wanted to attract foreign direct investment, create more jobs, facilitate economic benefits, and increase exports.⁹

Research shows that some zones have been successful, and some have failed. Traditionally, importers and exporters engaging in international business have used tax-free trade zones in order to benefit from fiscal incentives and lower local labor standards and wages.¹⁰ From experience, we have learned that in order to be successful, businesses using FTZs need to foster better business environments abroad, enhance their own economic competitiveness, concentrate on the integration of the zone into the domestic local economy, provide continuous innovation and upgrading, and ensure social and environmental sustainability of the zone.

Businesses benefit from FTZs because “[o]perating costs are lower in a zone as a result of reduced insurance, security, and overhead costs. Cash flow is enhanced by the ability to postpone duty payments until and only upon entry” of the goods into the domestic Customs Territory.¹¹ Foreign trade zones have been helpful to enable manufacturers to operate “just-in-time” systems (*i.e.* materials are purchased and units are produced only as needed to meet actual customer demand).¹² The efficiency advantages provided by these zones are arguably more important for industrialized countries, notwithstanding the advent of modern production approaches and the reduction of tariff and non-tariff barriers.¹³ The fact that zones are expanding in OECD countries suggests that they may be more than just tools for developing countries with bad policy environments—they may be critical to firm-level competitiveness in a globalized economic environment.¹⁴

B. What are FTZs and SEZs?

The Congressman most responsible for free trade legislation in the United States, Emmanuel Celler of New York, graphically defined a free trade zone as a neutral, stockaded area where a shipper can put down his load, catch his breath, and decide what to do next.¹⁵ The definition of a free trade zone, as well as proposed guidelines and standards for them, are contained in the Revised Kyoto Convention of the World Customs Organization (WCO).¹⁶

⁸ WB 2008 Report, *supra* note 6, at 3.

⁹ WB 2011 Report, *supra* note 2, at 3-4.

¹⁰ See *id.* at 4.

¹¹ *Id.* at 13.

¹² *Id.*

¹³ *Id.* at 6.

¹⁴ See *id.* at 13.

¹⁵ See Trampus Francesca, *Challenges, Threats and New Opportunities for the World's Free Zones*, TRASPORI. DIRITTO, ECONOMIA, POLITICA, 2003, at 61, available at http://www.openstarts.units.it/dspace/bitstream/10077/5595/1/TRAMPUS%20F_2003_89.pdf.

¹⁶ See WB 2008 Report, *supra* note 6, at 9 n.4 (Annex D of the International Convention on the Harmonization and Simplification of Customs defines a free zone as “part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs Territory...and not subject to the usual Customs control”).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

Tax-free trade zones,¹⁷ also known as special economic zones (SEZs), are public or private duty-free areas where goods may be warehoused, processed, sold, serviced, distributed, showcased, packaged, labeled, sorted, assembled and/or manufactured as finished goods prior to re-exporting them as duty-exempt finished products. FTZs exist in the United States but are referred to there as “foreign trade zones” rather than “free trade zones”.¹⁸ Some economists refer to tax-free trade zones generically as “special economic zones,” in order “to describe the broad range of modern economic zones.”¹⁹ SEZs are defined as “geographically delimited areas administered by a single body, offering certain incentives (generally duty-free importing and streamlined Customs procedures...) to businesses which [are] physically locate[d] within the zone.”²⁰ SEZs offer different and more advantageous rules of business with respect to “investment conditions, international trade and Customs, taxation, and the regulatory environment.”²¹ Generally, a free trade zone provides a more liberal business environment.²²

C. Stereotypes and Types of FTZs

Broadly speaking, while there are at least five different types of tax-free trade zones, they all fall into one of the three following stereotypes: (1) a small or large “fenced-in industrial estate in a developing country, populated by ... multinational corporations enjoying tax breaks, with laborers, [mostly women, toiling in sweatshops and] in garment factories... in substandard conditions”;²³ (2) an entire modern cosmopolitan city designated as a SEZ (like Shenzhen or Hong Kong in China);²⁴ or (3) a port that serves as a base for many types of trade-related activities.²⁵ There are actually five types of free trade zones, which will be defined more fully later: free trade zones (commercial-free zones); traditional export processing zones (EPZs) for export manufacturing only; free enterprises (single unit EPZs); hybrid EPZs (where only part of a large area is an EPZ), and free port special economic zones whose objective is integrated development.²⁶

D. Export-increasing Function of FTZs

FTZs can play a significant role in economic growth by increasing exports, by enhancing industry competitiveness, and by attracting foreign direct investment.²⁷ Special privileges are given to manufacturers who export the products processed in the FTZ. The purpose of a FTZ is “to develop and diversify exports while maintaining protective barriers, to create

¹⁷ See generally TIEFENBRUN, *supra* note 1 (for definitions of free trade zones and an encyclopedic listing and description of each of the 277 zones in the United States, with contact information and useful websites in the appendix).

¹⁸ See WB 2008 Report, *supra* note 6, at 13.

¹⁹ See, e.g. WB 2011 Report, *supra* note 2, at 3.

²⁰ WB 2008 Report, *supra* note 6, at 2.

²¹ WB 2011 Report, *supra* note 2, at 3.

²² See *id.*

²³ *Id.* at 1.

²⁴ *Id.*

²⁵ *Id.*

²⁶ See WB 2008 Report, *supra* note 6, at 3.

²⁷ *Id.* at 1.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

[more] jobs, and to pilot new policies and approaches” related to Customs, labor, public-private partnerships, law, society, and the environment.²⁸ The general belief is that in order to make a profit, a zone should concentrate on export processing. In 1980, there were only 59 foreign trade zones in the United States and only four of them were profitable because these four devoted 80% of their operations to export processing. In 2012, there are over 277 foreign trade zones in the United States, and this study will attempt to show that FTZs have an impact on US economy precisely because they enhance US exports.

Export processing zones (referred to as EPZs) focus on manufacturing of exports only and allow investors to import and export goods free of duties and exchange controls.²⁹ They facilitate licensing and other regulatory processes, and they usually free these businesses from “obligations to pay corporate taxes, value added taxes (VAT), or other local taxes.”³⁰ EPZs are “fenced-in estates with strict Customs controls at [their] entry, and [in which] sales are ... restricted mainly to export markets.”³¹

E. Objectives of FTZs

Tax-free trade zones have four policy objectives: (1) to attract foreign direct investment; (2) to alleviate unemployment; (3) to foster economic reform strategies by developing and diversifying exports; and (4) to test new approaches to foreign direct investment and to policies related to law, land, labor, and the pricing of goods.³² Tax-free trade zones “generat[e] foreign exchange through exports, and ... creat[e] ... economic value added.”³³

F. Global Proliferation of FTZs

Since 1980, there has been a rapid proliferation of special economic zones (especially export processing zones) all over the world.³⁴ In 2008, a World Bank Report covering 30 years of experience in special economic zones, confirmed that there were approximately 3,000 zones in 135 countries, creating 68 million direct jobs and over \$500 billion of direct trade-related value added within the zones.³⁵ Export processing zones are “highly effective tools for [increasing exports and] for job generation, particularly for women entering the workforce.”³⁶ Tax-free trade zones contribute to export development by accelerating export growth and export diversification.³⁷ These zones also help to increase the supply of goods.

²⁸ *Id.*

²⁹ See WB 2008 Report, *supra* note 6, at 10.

³⁰ WB 2011 Report, *supra* note 2, at 8.

³¹ *Id.*

³² See WB 2011 Report, *supra* note 2, at 3-4.

³³ *Id.* at 8.

³⁴ See WB 2008 Report, *supra* note 6, at 7.

³⁵ *Id.*; see also MARY JANE BOLLE & BROCK R. WILLIAMS, CONG. RESEARCH SERV., RL 7-5700, U.S. FOREIGN TRADE ZONES: BACKGROUND AND ISSUES FOR CONGRESS 1 (2012), available at www.crs.gov (quoting 66 million workers employed worldwide in FTZs).

³⁶ WB 2008 Report, *supra* note 6, at 3.

³⁷ *Id.* at 35.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

G. Success and Failure of FTZs

Notwithstanding the obvious advantages of tax-free trade zones that act as catalysts for economic growth and government policy adjustments, research tells us that not all zones in the world and in the United States have been successful,³⁸ either for importers or for exporters. “China is at the top of the list of success stories in attracting investment and promoting exports through SEZs. At the bottom of the list probably sits Africa, where, outside of Mauritius (and the partial success in Kenya, Lesotho, and Madagascar), most zone initiatives have been failures.”³⁹

1. Why Does a FTZ Fail?

Sometimes an “industry [can simply] tak[e] advantage of tax breaks without producing substantial employment or export earnings.”⁴⁰ Arguably, this approach benefits individual businesses but is driven by pure corporate greed that contributed to the causes of the global economic recession that began in 2008. Many of the EPZs “have been successful in attracting investment and creating employment only in the short term, but have failed to remain sustainable when labor costs have risen or when preferential trade access no longer offers a sufficient advantage.”⁴¹ As labor costs rise in China today, businesses that outsourced domestic manufacturing into China may see the need now to move their business elsewhere or even return the manufacturing to their own country. “[M]any SEZs have been successful in generating exports and employment, but [they have actually been only] marginally positive in cost-benefit assessments.”⁴² While “[m]any economists ... still view zones as a second- or even third-best solution to competitiveness,”⁴³ some claim that zones “have failed to extend benefits outside their enclaves or [have failed] to contribute to upgrading of skills and the production base.”⁴⁴

The negative social and environmental impacts of some tax-free trade zones over the years have been documented.⁴⁵ The World Bank Report of 2011 clearly states that

[z]one programs that fail to offer opportunities for quality employment and upward mobility of trained staff, which derive their competitive advantage from exploiting low-wage workers, and which neglect to provide an environment that addresses the particular concerns of female workers are unlikely to be successful in achieving the dynamic benefits possible from zones programs and likely will be forced into a race to the bottom. By contrast, zone programs that recognize the value of skilled workers and seek to

³⁸ WB 2011 Report, *supra* note 2, at 4.

³⁹ *Id.* at 11.

⁴⁰ *Id.* at 4.

⁴¹ *Id.*

⁴² *Id.*

⁴³ WB 2011 Report, *supra* note 2, at 4.

⁴⁴ *Id.*

⁴⁵ *Id.* at 17.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

provide the social infrastructure and working environment in which such workers thrive will be in a position to facilitate upgrading.⁴⁶

Thus, the social, labor, and environmental concerns of businesses are directly related to their economic performance.

2. What Accounts for the Success of a FTZ?

The success of tax-free trade zones takes time. There is an incubator period of at least five to ten years before a zone can build momentum.⁴⁷ The success of a zone is linked to many factors including its location, the way it is developed, and the way it is managed.⁴⁸ A zone should be located in an area that can leverage the country's comparative advantage. For example, Bangladesh initially tried to attract high-technology investment through its zone and later achieved greater success by focusing more on its garment sector in which Bangladesh has "a clear comparative advantage."⁴⁹ A zone can achieve success if properly serviced industrial land infrastructure is easily provided and if there is a reliable supply of power.⁵⁰ If local entrepreneurs have a role in catalyzing foreign direct investment, the zone will probably be successful, as was the case in Honduras and also in Bangladesh.⁵¹ Other factors contribute to the success of a zone, such as the critical role of the private sector to run the zone, the aid of the public sector to provide a regulatory framework, infrastructure, and services as well as port and road connections to the zones.⁵² The private sector can be more dynamic than the public sector in implementing zone regulations, and the private sector can offer an important source of expertise and risk management.⁵³

The legal framework in which a zone operates and the proper and consistent implementation of the rules are critical to the success of a zone.⁵⁴ An effective legal framework in a country that respects the rule of law is absolutely essential to the development of special economic zones. The legal and regulatory framework of the zone must be clear, transparent, and properly implemented in order to foster reliance and instill confidence in the foreign direct investors, who often face business challenges related to complicated land issues, undeveloped infrastructure, and compliance with labor and environmental standards.⁵⁵ There must be a reliable authority that has the capacity and the interest to enforce the rules in order to avoid inordinate delays and disputes that typically arise in zone projects.⁵⁶

Moreover, for a zone to be successful, it should not be an isolated enclave but rather "fully entwined with the competitiveness of the national economy and the national investment

⁴⁶ *Id.*

⁴⁷ *Id.* at 9.

⁴⁸ WB 2008 Report, *supra* note 6, at 57.

⁴⁹ WB 2011 Report, *supra* note 2, at 9.

⁵⁰ *Id.* at 10.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ WB 2011 Report, *supra* note 2, at 11.

⁵⁵ *Id.* at 11-12.

⁵⁶ *Id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

environment.”⁵⁷ Physical, financial, and strategic integration of a zone in the domestic economy can enhance the likelihood of the zone’s success,⁵⁸ the development of much-needed technical skills in the local labor force, the provision of training for women who would otherwise be house bound, and the fostering of innovation and upgrading of product quality.⁵⁹ Integration of the special economic zone into the domestic economy can bring about structural transformation, as was the case in China where zones were used to test liberal economic reforms and to introduce the Chinese people to the global market-reform economy in a gradual way.⁶⁰

Market access is another very important factor for the success of a zone. Zones can “link up regional suppliers and leverage economies of scale in production.”⁶¹ Linking regional special economic zones to infrastructure investments can enhance growth and competitiveness in a country.⁶²

The promotion of private rather than public development of zones can enhance the probability of the zone’s success. “The host government should aim to simplify investment approvals and expatriate work permits; remove required import and export licenses; and accelerate Customs inspection procedures and automatic foreign exchange access.”⁶³

Finally, ensuring the flexibility of the FTZ program will foster the development of a range of commercial and manufacturing activities that must be properly supervised.⁶⁴ Flexibility with an eye toward structural improvement will enhance the success of the zone.

H. Threats to FTZ Expansion

We have shown that tax-free trade zones can serve as “pressure valves” to alleviate the serious global problem of unemployment.⁶⁵ Such zones can and do attract foreign direct investment because of the tax advantages and Customs privileges that save time and expense for business people. Free trade zones located in an underdeveloped country can facilitate the transfer of much needed technology through backward linkages.⁶⁶ Thus, FTZs can promote the increase of exports, create jobs, and transfer technology, which are benefits that can and should have a positive impact on the U.S. economy.

Despite the proliferation of tax-free trade zones all over the world and their undeniable benefits to the economy and to society, these zones face threats from changing regulatory environments and the increasing importance of regional preferential trade agreements.⁶⁷ Bilateral and regional trade agreements are growing rapidly around the world, and this devel-

⁵⁷ *Id.* at 11. The WB 2011 Report argues that zones should be integrated into the domestic economy for success; however, it recognizes that where economic reforms are politically sensitive and therefore difficult to implement, it is better to have a zone that is an enclave. *Id.* at 15.

⁵⁸ *See id.* at 16.

⁵⁹ *See* WB 2011 Report, *supra* note 2, at 15.

⁶⁰ *Id.*

⁶¹ *Id.* at 13.

⁶² *Id.*

⁶³ WB 2008 Report, *supra* note 6, at 5.

⁶⁴ *Id.*

⁶⁵ *Id.* at 12.

⁶⁶ *See id.* at 14.

⁶⁷ WB 2011 Report, *supra* note 2, at 12-13.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

opment may cause changes in the rules of FTZs in general and export processing zones in particular.⁶⁸

I. Names of Zones.

There are many different names for Customs-privileged facilities. FTZs are also called free ports, transit zones, free perimeters, and there are special types of facilities known as “subzones,” traditional export processing zones (EPZs), hybrid EPZs, enterprise zones, empowerment zones, urban free zones, single factory EPZs, and special economic zones (SEZs).

1. Free trade zone is a commercial free zone that is a small, enclosed, duty-free area “offering warehousing, storage, and distribution facilities for trade, trans-shipment, and re-export operations located in most ports of entry around the world.”⁶⁹ The Colon Free Zone in Panama is one of the leading examples of a successful FTZ.

2. Free port encompasses a much larger area including an entire port and the surrounding area which accommodates all types of activities including tourism and retail sales, and it is an area where people can actually reside on site. Hong Kong is a large-scale free port in China. Foreign goods may be introduced into free ports without being subject to Customs duties and without having many restrictions governing their entry, handling, processing, and re-export. Thus, free ports are the most flexible form of Customs-privileged facilities.

3. Transit Zone, which is sometimes called a “free zone” or “free transit zone,” is a port of entry in a coastal country serving as a storage and distribution center. The transit zone is more limited than the free trade zone or the free port, and it may consist of only one warehouse in the port. The best known and most successful transit zone is Bangkok.

4. Free Perimeter is similar to a free port but is located in a remote or undeveloped region of a country in order to serve the local population. In free perimeters tariffs are not exempted but simply reduced, and free perimeters handle only specific imports.

5. Export Processing Zone (EPZ) is an industrial estate offering special incentives and facilities for manufacturing aimed mostly at export markets.⁷⁰ There are two forms of EPZs. In the traditional EPZ, “the entire zone is [designed] exclusively for export-oriented enterprises that are licensed under an EPZ regime.”⁷¹ A “hybrid EPZ” is sub-divided into a general zone open to all businesses whether or not their products are exported, and “a separate EPZ area reserved specifically for export-oriented [and] EPZ-registered enterprises”⁷² (like Thailand and the Philippines).⁷³

6. Single Factory EPZ “provide[s] incentives to individual enterprises regardless of their location.”⁷⁴ The factories do not have to be located within a designated zone to receive privileges.⁷⁵ Mauritius, Madagascar, Mexico, and Fiji are examples of single factory EPZs.⁷⁶

⁶⁸ *Id.* at 13.

⁶⁹ See WB 2008 Report, *supra* note 6, at 10.

⁷⁰ WB 2008 Report, *supra* note 6, at 10.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.* at 11.

⁷⁵ WB 2008 Report, *supra* note 6, at 11.

⁷⁶ *Id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

7. Enterprise zone (also called an “empowerment zone”) is designed to revitalize a distressed urban or rural area located primarily in developed countries like the United States, France, and England, by providing tax incentives and financial grants.⁷⁷

8. Specialized zone is part of a zone project that cannot be accommodated within an existing general purpose zone. General purpose zones “include science/technology parks, petrochemical zones, logistics parks, and airport-based zones.”⁷⁸

J. FTZ Benefits to Importers and Exporters

Both importers and exporters benefit from FTZs because both save on taxes, reduce transportation costs, avoid financing charges, and thereby increase their business cash flow. Exporters see FTZs as an entry into foreign markets, a vehicle to defer or avoid Customs duties, and a way to obtain income tax exemptions or reductions. FTZs offer special Customs treatment that is designed to stimulate international trade.⁷⁹ The exemption of Customs duties on goods in FTZs is a feature that attracts foreign investors to the country where the FTZ is located and thereby increases foreign direct investments in that country.⁸⁰ FTZs also provide importers and exporters with inexpensive land and plants, easy access to raw materials for use in production for re-export, and the availability of nearby markets for finished goods. Thus, FTZs are a useful tool for a country’s economic growth by increasing industry competitiveness and by attracting foreign direct investment.⁸¹

Exporters rely on free trade zones to serve as a “necessary doorstep” to their foreign customers, no matter where the customers are located.⁸² In the FTZ the exported goods may be warehoused, processed, sold, or serviced prior to distribution or delivery, usually within a 24-hour period. Income tax holidays or reductions frequently accompany the Customs duty-free benefits.⁸³ FTZs offer many advantages to exporters including inexpensive land and plant costs, easy access to raw materials in neighboring countries for importation and their use in production for re-export, and the availability of nearby markets for finished goods.⁸⁴

K. Statistics on FTZs

Within the last few years small and large international companies in all corners of the globe have discovered that tax-free trade zones can prove to be an effective tool to develop new markets and to increase earnings from existing foreign trade and manufacturing operations. Presently, there are over 3,500 tax-free trade zones, free ports, and similarly desig-

⁷⁷ *Id.*

⁷⁸ *Id.* at 3.

⁷⁹ See generally WB 2008 Report, *supra* note 6; see also WB 2011 Report, *supra* note 2.

⁸⁰ See generally WB 2008 Report, *supra* note 6; see also WB 2011 Report, *supra* note 2.

⁸¹ See generally WB 2008 Report, *supra* note 6; see also WB 2011 Report, *supra* note 2.

⁸² DIAMOND & DIAMOND, *supra* note 1, at 1.

⁸³ See e.g., WB 2011 Report, *supra* note 2, at 36-37.

⁸⁴ See e.g., *id.* at 58.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

nated areas of the world, including about 277 foreign trade zones and more than 500 special purpose subzones in the United States.⁸⁵

Most export activity in the U.S. foreign trade zones is located in the many subzones (500). Free trade zones enable importers and exporters to benefit from a variety of Customs-privileged facilities that offer them government guarantees, incentives, and numerous other advantages.⁸⁶ By seeking the sheltered areas of the U.S. foreign trade zones or the free trade zones of the world that are best suited to their needs, companies engaged in processing and assembling components into a finished product can also save on corporate taxes, duties, and trim costs, including transportation expenses, rental fees, wages, finance charges, and insurance premiums.⁸⁷

Today, thousands of imported products, from delicate caviar to sophisticated electronics and machinery, are lodged in free trade zones located in 135 countries. The free trade zones abroad and the U.S. foreign trade zones together reportedly have employed more than 43 million workers.⁸⁸ Domestic or foreign enterprises buying products from abroad can store goods in a Customs-free facility prior to shipment into the country where the zone is located. Storage in a free trade zone can result in substantial savings in financing charges and increased cash flows. Some importers depend upon free trade zones to package, label, sort, assemble, process or manufacture finished goods prior to re-exporting their duty-exempt finished products.⁸⁹

L. More About the Terms Related to Free Trade Zones

A *free trade zone* (FTZ) in the United States is often referred to as a *foreign trade zone*, which is a restricted-access site, in or adjacent to a Customs and Border Protection port of entry.⁹⁰ An FTZ is operated pursuant to public utility principles under the sponsorship of a corporation that is granted authority by the U.S. Foreign Trade Zones Board, pursuant to the U.S. Foreign Trade Zones Act⁹¹ and regulations.⁹² The FTZ is under the supervision of the

⁸⁵ All figures and information relating to tax free trade zones in the 71st Annual Report of the Foreign Trade Zones Board are subject to change without notice. A good resource online for free trade zones is: List of Foreign Trade Zones by State, INT'L TRADE ADMIN. (Jan. 10, 2013), <http://ia.ita.doc.gov/ftzpage/letters/ftzlist-map.html>. Although the List of Free Trade Zones shows 277 foreign trade zones in the United States, there are actually only 260 in operation at this time. *Id.*

⁸⁶ See generally WB 2008 Report, *supra* note 6; WB 2011 Report, *supra* note 2.

⁸⁷ See generally Greg Jones, *U.S. Foreign-Trade Zones Give A Competitive Edge to U.S. Based Companies and American Communities*, BUS. DEV. OUTLOOK, Sept.15, 2006, at 1-4, available at <http://www.ftzcorp.com/ArticleDetails/tabid/210/ArticleID/10/Default.aspx>.

⁸⁸ See *International Free Trade Zone*, ECON. WATCH (June 30, 2010), <http://www.economywatch.com/international-trade/free-trade-zone.html>.

⁸⁹ See generally Greg Jones, *Using Foreign Trade Zones as a Local Economic Development Tool*, FOREIGN TRADE ZONE CORP. (Sept. 15, 2006), available at <http://www.ftzcorp.com/ArticleDetails/tabid/210/ArticleID/11/Default.aspx>.

⁹⁰ See FOREIGN-TRADE ZONES BD., 57TH ANNUAL REPORT OF THE FOREIGN-TRADE ZONES BOARD TO THE CONGRESS OF THE UNITED STATES 1 (Sept. 30, 1995), available at <http://ia.ita.doc.gov/ftzpage/ftzar-95.html>, [hereinafter, 57TH ANNUAL REPORT].

⁹¹ See United States Foreign Trade Zones Act, 19 U.S.C. §§ 81a-81u (1934).

⁹² See *id.*; see generally FTZ Regulations, 15 C.F.R. § 400 (2012).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

U.S. Customs and Border Protection (CBP) of the U.S. Department of Homeland Security.⁹³ FTZs are secure areas under U.S. Customs supervision and are considered outside the Customs Territory upon activation.⁹⁴

There are many synonyms for the word “free trade zone”. Traditionally and since the 19th century, the FTZ has been referred to as a “free trade zone”. It is also referred to as a *foreign trade zone* in the United States as well as in India since 1983.⁹⁵ An FTZ was also referred to as an *industrial free zone* in Ireland before 1970.⁹⁶ Other synonyms include *free zone* (United Arab Emirates), *maquiladoras* (Mexico), *export free zone* (Ireland in 1975), *duty free export processing zone* (Republic of Korea in 1975), *export processing zone* (Philippines in 1977), *special economic zone* (China in 1979), *investment promotion zone* (Sri Lanka in 1981), and a *free export zone* (Republic of Korea).⁹⁷

In the United States, authority for establishing an FTZ is granted by the *Foreign Trade Zone Board* (the Board) under the U.S. Foreign Trade Zones Act of 1934, as amended (19 U.S.C. 81a–81u).⁹⁸ The Executive Secretariat of the Board is located in the Import Administration of the U.S. Department of Commerce in Washington, D.C. “Foreign trade zone[s] ... are subject to the laws and regulations of the United States as well as [the laws] of the states and communities in which these zones are located.”⁹⁹

In a free trade zone, “the usual formal *customs entry procedures* and payments of duties are not required for the foreign merchandise unless and until it enters Customs Territory for domestic consumption.”¹⁰⁰ At that point, the importer “has the choice of paying duties at the rate of either the original foreign materials or the finished product.”¹⁰¹ “Domestic goods moved into the zone for export are considered exported upon [admission to] the zone for purposes of excise tax rebates and drawbacks.”¹⁰² FTZs are sponsored by qualified public or private corporations.¹⁰³ Operations of the FTZ are “conducted on a public utility basis, with published rates.”¹⁰⁴

Free trade zones are divided into *general purpose zones* and *subzones*. “General purpose zones” involve public facilities that can be used by more than one firm.¹⁰⁵ They are

⁹³ 57TH ANNUAL REPORT, *supra* note 90, at 1.

⁹⁴ *Id.*

⁹⁵ U.N. ECON. AND SOCIAL COMM’N FOR ASIA AND THE PACIFIC, FREE TRADE ZONE AND PORT HINTERLAND DEVELOPMENT 6 (2005), available at http://www.unescap.org/ttdw/Publications/TFS_pubs/pub_2377/ftz_fulltext.pdf.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ See United States Foreign Trade Zones Act of 1934, 19 U.S.C. §§ 81a–81u (1934); 57TH ANNUAL REPORT, *supra* note 90, at 1.

⁹⁹ *Introduction to Foreign Trade Zone – FTZ Procedures*, INT’L BUS. & TRADE HELP CENTER (July 2012), <http://www.importexporthelp.com/foreign-trade-zone.htm> [hereinafter *FTZ Procedures*].

¹⁰⁰ *Id.* (emphasis added). See also Greg Jones, *U.S. Foreign-Trade Zone Program Use Grows Among U.S. Based Manufacturing Operations*, FOREIGN TRADE ZONE CORP. (Sept. 15, 2010), available at <http://www.ftzcorp.com/ArticleDetails/tabid/210/ArticleID/12/Default.aspx>, [hereinafter *U.S. FTZ Program Use Grows*].

¹⁰¹ *FTZ Procedures*, *supra* note 99.

¹⁰² 57TH ANNUAL REPORT, *supra* note 90, at 2.

¹⁰³ *Id.* at 2.

¹⁰⁴ *Id.*

¹⁰⁵ See *id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

usually located in industrial parks or ports, and they are used by small and medium-sized businesses that lease space for storage, warehousing, distribution, processing or assembly of merchandise.¹⁰⁶ Generally, the warehousing buildings provide access to various modes of transportation.

Subzones are sponsored by general purpose zones. Subzones are private plant sites authorized by the Board and sponsored by a grantee for operations that typically cannot be accommodated within an existing general purpose zone.¹⁰⁷ The subzone is usually only one firm's site that is used for more extensive manufacturing, processing or warehousing and distribution of goods. Most export activity emanates from subzones.

Special purpose zones are established as part of a zone project for a limited purpose that cannot be accommodated within an existing general purpose zone.¹⁰⁸

An *enterprise zone* is a specific geographic area targeted for economic revitalization. Enterprise zones encourage economic growth and investment in distressed areas by offering state tax advantages and incentives to businesses located within the zone boundaries.¹⁰⁹

An *empowerment zone* is similar to an enterprise zone. An empowerment zone is a highly distressed urban or rural community which may be eligible for a combination of grants, tax credits for businesses, bonding authority, and other benefits under the U.S. Empowerment Zone Program.¹¹⁰ This program is primarily managed through partnerships between the local entity and either the Department of Housing and Urban Development (HUD) for urban empowerment zones or the U.S. Department of Agriculture (USDA) for rural empowerment zones.¹¹¹ Qualifying businesses located in empowerment zones are eligible for employment tax credits, low cost loans, increased Section 179 tax deductions, partial-exclusion of tax on capital gains upon the sale of certain assets, and other economic benefits.¹¹² The empowerment zone employment credit provides businesses with an incentive to hire individuals who both live and work in an empowerment zone.¹¹³

A free trade zone may apply for the authority to reorganize itself into an *alternative site framework* referred to as an "ASF". The ASF is an option for grantees to establish an FTZ or reorganize an existing general-purpose zone.¹¹⁴ This reorganization can permit significantly greater flexibility in the designation of new "usage-driven" FTZ sites for operators or users located with a grantee's service area.¹¹⁵ For example, in June 2010, shippers who were in a

¹⁰⁶ See *Glossary of FTZ Terms*, U.S. FOREIGN-TRADE ZONES BD., <http://ia.ita.doc.gov/ftzpage/info/zonetypes.html> (last visited Jan. 11, 2013) (defining "general purpose zones" and "subzones") [hereinafter *Glossary of FTZ Terms*].

¹⁰⁷ See *id.*

¹⁰⁸ See *General Definitions*, FOREIGN-TRADE ZONE RES. CTR., http://www.foreign-trade-zone.com/g_definitions.htm (last visited Jan. 11, 2013) (defining "subzones") [hereinafter *General Definitions*].

¹⁰⁹ See WB 2008 Report, *supra* note 6, at 11.

¹¹⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-727, EMPOWERMENT ZONE AND ENTERPRISE COMMUNITY PROGRAM: IMPROVEMENTS OCCURRED IN COMMUNITIES, BUT THE EFFECT OF THE PROGRAM IS UNCLEAR 8 (2006), available at <http://www.gao.gov/new.items/d06727.pdf>.

¹¹¹ *Id.*

¹¹² See *id.*

¹¹³ See *id.* at 27.

¹¹⁴ See *Ensuring Your Foreign-Trade Zone Alternative Site Management Framework is a Success*, FOREIGN-TRADE ZONE CORP., (2012), <http://www.ftzcorp.com/ftz-services/alternative-site-management-framework-asf.aspx>.

¹¹⁵ See *id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

hurry to establish a foreign trade zone for their New Orleans warehousing and distribution operations applied for an FTZ Alternative Site Framework in order to streamline the application process.¹¹⁶ Fortunately, the New Orleans port participates in the ASF program.¹¹⁷ The ASF program allows existing companies and new companies in the New Orleans, Jefferson, or St. Bernard parishes to secure FTZ status within about 30 days after the application is accepted.¹¹⁸ Without the ASF program, an application to establish an FTZ or to increase the size of an existing FTZ could take approximately three months.¹¹⁹

A *grantee* is a corporation that is granted by the Foreign Trade Zones Board the permission to establish, operate, and maintain a foreign trade zone.¹²⁰ Grantee corporations must be either public corporations including a state, a political subdivision, public agency, corporate municipal instrumentality of one or more states or private corporations organized for the purpose of establishing a zone project.¹²¹ Qualified private corporations must be chartered for this purpose under a law of the state in which the zone is located. The responsibilities of a grantee of a FTZ project are set forth in the U.S. Foreign Trade Zones Act, the Foreign Trade Zones Board Regulations, and the U.S. Customs Regulations.¹²² “The grantee files all applications with the Foreign-Trade Zones Board.”¹²³ In addition to the original application to establish a FTZ and a zone project, “the grantee files all applications to expand the zone and establish subzones.”¹²⁴ “The grantee also files requests – such as minor boundary modifications – that are handled as administrative actions by the Foreign-Trade Zones Board.”¹²⁵ The grantee is responsible for site selection and maintenance of zone facilities.¹²⁶ The grantee must make sure “the entire zone project ... is operated under public utilities principles.”¹²⁷ The grantee is responsible for filing all annual reports to the FTZ Board.¹²⁸ Moreover, the grantee must maintain the following documents concerning the zone project: grant of authority, Board Orders, applications/requests submitted to the FTZ Board including applications, boundary modification requests, manufacturing/processing requests, and grantee/operator agreements. The grantee may choose an operator of the zone or decide to act as the zone operator him or herself.¹²⁹

¹¹⁶ Breakbulk Staff, *New Orleans Approved for FTZ Alternative Site Framework*, BREAKBULK (June 4, 2010, 4:01 PM), <http://www.breakbulk.com/portterminals/new-orleans-approved-ftz-alternative-site-framework>.

¹¹⁷ *Id.*

¹¹⁸ Integration Point Global Trade News Team, *Port of New Orleans Receives Speedy FTZ Approval*, FOREIGN TRADE ZONE NEWS (June 25, 2010), available at <http://www.integrationpoint.com/foreigntradezonenews/index.php/2010/06/port-of-new-orleans-receives-speedy-ftz-approval/>.

¹¹⁹ *Id.*

¹²⁰ *Glossary of FTZ Terms*, *supra* note 106 (defining “grantee”).

¹²¹ See *Grantee Information*, U.S. FOREIGN-TRADE ZONES BD., <http://ia.ita.doc.gov/ftzpage/grantee/regs.html#400.12> (last visited Apr. 16, 2012) (describing eligibility requirements).

¹²² See *Responsibilities of the Zone Grantee*, FOREIGN TRADE ZONE RES. CTR., http://www.foreign-trade-zone.com/grantee_respon.htm (last visited Apr. 16 2102) [hereinafter *Responsibilities of the Zone Grantee*].

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Responsibilities of the Zone Grantee*, *supra* note 122.

¹²⁸ *Id.*

¹²⁹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

The zone *operator* is required by Customs to be bonded. “The grantee must decide who will run the [z]one and what services the [z]one project will offer.”¹³⁰ The grantee also decides who the zone operator will be.¹³¹ A zone operator has many possible jobs. He or she may be a warehouse person, a real estate developer, or an administrator of the zone.¹³² “Some [FTZ] [g]rantees elect to operate the General Purpose Zone themselves” in order to maintain the greatest direct control over the zone operations.¹³³ This choice makes the grantee/operator liable.¹³⁴ “Many ... Grantees subcontract the responsibility to operate the General Purpose Zone to a separate company in an attempt to distance themselves from substantial liability.”¹³⁵

Manufacturing in a FTZ refers to “activity involving the substantial transformation of a foreign article resulting in a new and different article having a different name, character, and use.”¹³⁶ This substantial transformation can affect the “origin” of the merchandise for purposes of Customs and tariffs.

Merchandise received into a FTZ space includes *foreign status merchandise* and *domestic status merchandise*. *Domestic status merchandise* (also referred to as “domestic status inputs”) is the Customs status for domestic-origin and duty-paid foreign-origin zone merchandise.¹³⁷ “Foreign status merchandise” (also referred to as “foreign status inputs”) is merchandise admitted to a zone site under United States Customs and Border Protection supervision that is normally of foreign origin.¹³⁸ Foreign status merchandise is “admitted to zone sites without being subject to formal Customs entry procedures and payment of duties, unless and until the foreign merchandise enters Customs Territory for domestic consumption.”¹³⁹

Foreign status merchandise is either *non-privileged foreign* or *privileged foreign* merchandise. “Privileged foreign status” is one of two Customs categories of foreign status merchandise.¹⁴⁰ “Privileged foreign status” applies to merchandise of foreign origin when classified and appraised with duties liquidated and taxes determined as of the date the application for this status is approved.¹⁴¹ Privileged foreign status allows the importer to alter or manufacture merchandise into new products without changing, for duty-assessment purposes, the original product classification.¹⁴² Foreign status merchandise maintains its status based on its condition when admitted to the zone.¹⁴³ When the merchandise is shipped from the zone to the U.S. market and is entered for consumption by the Customs and Border Protection, it is evaluated based on the time-of-admission condition, even though it might have undergone a

¹³⁰ Greg Jones, *Selecting an Operator*, FOREIGN TRADE ZONE RES. CTR., http://www.foreign-trade-zone.com/choosing_operator.htm. (last visited July 20, 2012) [hereinafter *Selecting an Operator*].

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ 15 C.F.R. § 400.2(g) (2012).

¹³⁷ 19 C.F.R. § 146.43 (2012).

¹³⁸ See *Glossary of FTZ Terms*, *supra* note 106 (defining “Foreign Status”).

¹³⁹ *Id.*

¹⁴⁰ See *id.*; see also 19 C.F.R. § 146.41-42.

¹⁴¹ *General Definitions*, *supra* note 108 (defining “privileged foreign status”).

¹⁴² See 19 C.F.R. § 146.41.

¹⁴³ *Id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

transformation in the zone.¹⁴⁴ Prior to any manufacture or manipulation of the merchandise which could change its tariff classification, an importer may apply to the port director to have imported merchandise in the zone given privileged foreign status.¹⁴⁵ After classification and appraisal, and “when [this] merchandise is transferred from the zone for U.S. consumption, either in its original state or after [it is] ... manufacture[d], the applicable duties and taxes would be paid based on the rate established when foreign privileged status was granted.”¹⁴⁶ Privileged foreign status cannot be abandoned even though the form of the merchandise has been changed. However, this status cannot be granted to non-privileged foreign merchandise, which has previously been manufactured in a zone.

Non-privileged foreign status is the second of the two Customs categories of foreign status merchandise. Non-privileged foreign status applies to merchandise of foreign origin, but it can also apply to certain domestic merchandise which, because of its non-compliance with foreign trade zone regulations, has lost its domestic status.¹⁴⁷ “Non-privileged Foreign status allows Zone users to pay duty based on the character, condition and quantity of the merchandise at the time it enters Customs territory”¹⁴⁸ for consumption or for Customs bonded warehousing.¹⁴⁹ “Merchandise composed entirely of or derived entirely of nonprivileged merchandise are appraised and classified in its condition at the time of transfer into [the Customs Territory].”¹⁵⁰ Non-privileged foreign status is a residual category for merchandise which does not have privileged or zone restricted status.

FTZs provide relief from *inverted tariff rates*.

Inverted tariff ... [rates] penalize companies for making their products in the United States. The U.S. FTZ Program enables companies to apply to the FTZ Board for the authority to obtain relief from inverted tariffs when a component item or raw material is subject to a higher duty rate than the finished product. Hence, the importer of the finished product pays a lower duty rate than the manufacturer of the same product in the United States. This gives the importer an unfair and unintended advantage over the domestic manufacturer. The Foreign Trade Zones Program levels the playing field in these circumstances.¹⁵¹

¹⁴⁴ See *General Definitions*, *supra* note 108 (defining “privileged foreign status”).

¹⁴⁵ 19 C.F.R. § 146.43 (2012).

¹⁴⁶ *FTZ Procedures*, *supra* note 99.

¹⁴⁷ 19 C.F.R. § 146.42 (2012).

¹⁴⁸ *What Happens in Foreign Trade Zones*, HAWAII FOREIGN TRADE ZONE NO. 9, <http://www.ftz9.org/index.php?action=21> (last visited March 3, 2013).

¹⁴⁹ *Non-Privileged Foreign Status, About Foreign-Trade Zones & Contact Info*, CPB.GOV, http://www.cbp.gov/xp/cgov/trade/cargo_security/cargo_control/ftz/about_ftz.xml (last visited March 6, 2013).

¹⁵⁰ *Id.*

¹⁵¹ *Relief from Inverted Tariff When Manufacturing in a Foreign-Trade Zone or Subzone*, FOREIGN-TRADE ZONE CORP., <http://www.ftzcorp.com/foreign-trade-zone-benefits/relief-from-inverted-tariffs.aspx> (last visited Nov 21, 2012).

M. History of Free Trade Zones

Historically, the free trade zone was a tool for aggressive commercial powers. The free trade zone dates back to the time of the ancient Phoenicians, when safe passage was the chief guarantee offered foreign traders visiting Tyre and Carthage. Later the Greek city-states and then the Romans developed it into launching pads for economic and political domination. The free trade zone also helped to enrich members of the Hanseatic League. However, it was not until the later part of the 1960s that free trade zones began to play a significant role in international trade.

The developing countries neglected to focus on free trade zones until the late 1960s, after the United Nations' Economic and Social Council adopted a resolution¹⁵² suggesting the benefits of improving port, Customs, and trade zone facilities in developing countries. Soon afterwards, the United Nations Industrial Development Organization (UNIDO) drew up a plan for a model free trade zone. Several governments have adopted UNIDO's provisions for free trade zone administration, infrastructure, tax holidays, and other investment incentives. Moreover, European Council Regulations on Customs warehouses and on free zones and free warehouses were approved. These rules establish warehousing and free zone procedures which are now uniformly regulated and used as an essential instrument in promoting European Union trade.¹⁵³

N. Free Trade Zones vs. Free Trade Areas

There is a difference between a free trade zone and a free trade area. The areas in the North American Free Trade Agreement (NAFTA) and the European Union are free trade areas. With the signing of NAFTA, all duties on goods traded among Canada, Mexico, and the United States were eliminated.¹⁵⁴ Although some concern was expressed about the future of free trade zone operations and their role in facilitating world trade in the light of the development of free trade areas such as NAFTA and the EU, NAFTA and other free trading areas created around the globe have not impeded the flow of trade into or out of the traditional free trade zones located in designated areas within a host country. For instance, in the case of Mexico, the long-established *maquiladora* along the border with the United States has not diminished in importance since the signing of NAFTA. Foreign investments did not move out; in fact "the Maquiladora program has seen an increase in maquila facilities as more companies elect to move productive facilities to Mexico."¹⁵⁵ Nevertheless, objections to NAFTA have been raised by powerful United States labor unions pressuring Washington to terminate USAID and other Government agency payments designed to fund export processing zones overseas.

¹⁵² See E.S.C. Res. 1273 (XLIII), 43rd Sess., Supp. No. 1, U.N. Doc. E/4429, at 5 (Aug. 4, 1967). See also UN ECOSOC, 43rd Sess., 1506th plen. mtg. at 206-07 (Aug. 4, 1967).

¹⁵³ See Commission to the Council (EC) No. 85/C 283/04 of 10 October 1985(Customs warehouses); Commission to the Council (EC) No. 85/C 283/05 of 10 October 1985(free zones and free warehouses).

¹⁵⁴ See North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993).

¹⁵⁵ Gerard Morales, Benjamin Aguilera & David K. Armstrong, *An Overview of the Maquiladora Program*, BUREAU OF INT'L LABOR AFFAIRS (1994), available at <http://www.dol.gov/ilab/media/reports/nao/maquilad.htm>. See also M. ANGELES VILLARREAL, CONG. RESEARCH SERV., RL32934, U.S.-MEXICO ECONOMIC RELATIONS: TRENDS, ISSUES, AND IMPLICATIONS, at 9 (2012).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

In 2008, 2,301 zones existed in 119 developing and transition countries, clustered mainly in Asia and the Pacific and the Americas. In the developing nations, surveys show that multinationals plan to invest in free trade zones where host countries offer income tax exemptions and other investment incentives, including accelerated depreciation, and investment grants and credits, as well as the traditional “pioneer” tax holiday. Moreover, countries that are not members of such free trade areas as the European Union, NAFTA, the Pacific Basin Free Trade Area, or Mercosur (which includes Argentina, Brazil, Paraguay and Uruguay) intend to promote the use of their zones to compete with participants of trade groups. Nations without regional group membership that are offshore financial centers such as Cyprus, Madeira, Malta, and Labuan in Malaysia, and that combine tax-exempt banking units with the absence of income taxes for trading companies in their zones are benefiting from the overall trend to operate in regional Customs-free zones.

II. FOREIGN TRADE ZONES IN THE U.S.

Despite fears and some objections to foreign trade zones in general, in July 2012 the National Association of Foreign-trade Zones reported substantial growth in merchandise received and goods exported,¹⁵⁶ with International Automotive Manufacturing leading zone export growth,¹⁵⁷ and Texas leading all states in zone activity.¹⁵⁸ There has been a steady increase in zone activity in the United States. For example, in 2008 the Foreign Trade Zones Board approved one new general purpose zone and 20 new subzones;¹⁵⁹ in 2009 the Board approved two new general purpose zones and 26 new subzones.¹⁶⁰ According to the 70th Annual Report of the FTZ Board, “[t]he combined value of shipments into general-purpose zones and subzones totaled over \$692 billion [in 2009], compared with \$502 billion in the previous year [2008] . . . General-purpose sites received nearly \$75 billion in merchandise. Total shipments received at subzone sites amounted to over \$617 billion.”¹⁶¹ Exports from foreign trade zones were \$40 billion.¹⁶² Moreover, foreign trade zones in the United States employed over 330,000 persons in 2009. The oil refining, automotive, pharmaceutical, and electronic products industries are heavy users of foreign trade zones.¹⁶³

According to the 71st Annual Report of the FTZ Board to the Congress of the United States, in 2009, the FTZ Board issued 70 formal orders including approvals for two new

¹⁵⁶ NATIONAL ASS’N OF FOREIGN-TRADE ZONES, THE IMPACT OF FOREIGN-TRADE ZONES ON THE 50 STATES & PUERTO RICO 2 (2012), available at <http://www.naftz.org/wp-content/uploads/2012/10/2012-State-by-State-Study.pdf>.

¹⁵⁷ *Id.* at 6.

¹⁵⁸ *Id.* at 2-5; Brian Hannigan & Brian Picone, *Foreign-Trade Zones a Bright Spot in U.S. Economic Recovery, Study Shows*, GLOBENEWSWIRE, July 18, 2012, <http://globenewswire.com/news-release/2012/07/18/273850/262649/en/Foreign-Trade-Zones-a-Bright-Spot-in-U-S-Economic-Recovery-Study-Shows.html>.

¹⁵⁹ FOREIGN-TRADE ZONES BD., 70TH ANNUAL REPORT OF THE FOREIGN-TRADE ZONES BOARD TO THE CONGRESS OF THE UNITED STATES 1 (2009), available at www.trade.gov/ftz [hereinafter 70TH ANNUAL REPORT].

¹⁶⁰ FOREIGN-TRADE ZONES BD., 71ST ANNUAL REPORT OF THE FOREIGN-TRADE ZONES BOARD TO THE CONGRESS OF THE UNITED STATES 1 (2010), available at www.trade.gov/ftz [hereinafter 71ST ANNUAL REPORT]. The 2011 Report is not available, as of March, 2012.

¹⁶¹ 70TH ANNUAL REPORT, *supra* note 159, at 1.

¹⁶² *Id.* at 2.

¹⁶³ 71ST ANNUAL REPORT, *supra* note 160, at 2.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

general-purpose zones and 26 new subzones.¹⁶⁴ There were 168 FTZ projects fully active during the year, with subzones in operation in more than 114 of these zones.¹⁶⁵ The number of facilities using subzone status during 2009 was 261.¹⁶⁶ The combined value of shipments into the zones and subzones totaled over \$430 billion in 2009, compared to \$692 billion the previous year (reflecting the impact of the global recession on international trade in 2008).¹⁶⁷ In 2009, “[g]eneral-purpose sites received nearly \$76 billion in merchandise.”¹⁶⁸ In 2008, the general purpose zones received around \$75 billion in merchandise.¹⁶⁹ In 2009, “the combined value of shipments received into general-purpose zones and subzones totaled over \$430 billion, compared with \$692 billion the previous year.”¹⁷⁰ That year, “total shipments received at subzone sites amounted to \$354.7 billion.”¹⁷¹ In 2008, the total number of shipments received into subzones was \$617.7 billion.¹⁷² Around “82 percent of zone activity took place at subzone facilities, which is consistent with the pattern of the past 15 years,” according to the 71st Annual Report of the FTZ Board.¹⁷³ But it is clear from the statistics that 2009 showed a decline in the total shipments received in subzones and total exports from subzones due to the global recession.

The 71st Annual Report of the FTZ Board also showed that exports from the U.S. to foreign countries from facilities operating under FTZ procedures amounted to more than \$28 billion in 2009.¹⁷⁴ This figure “do[es] not include certain indirect exports involving FTZ merchandise that undergoes further processing in the United States at non-FTZ sites prior to export.”¹⁷⁵

In 2009, “approximately 330,000 persons were employed at some 2,500 firms operat[ing] under FTZ procedures.”¹⁷⁶ The main foreign-origin products received at general purpose zones in 2009 were consumer electronics, other metals and minerals, vehicles, petroleum products, textiles, footwear and leather, other electronics products and parts, vehicle parts, machinery and equipment.¹⁷⁷ The main foreign-origin products received at subzones in 2009 were crude oil, petroleum products, pharmaceutical products, vehicle parts, vehicles, other consumer products, other electronics products and parts, chemical products, etc.¹⁷⁸

Industries that accounted “for most zone manufacturing activity [in 2009] included the oil refining, automotive, pharmaceutical, and machine/equipment sectors.”¹⁷⁹ It is im-

¹⁶⁴ *Id.* at 1.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ 70TH ANNUAL REPORT, *supra* note 159, at 1.

¹⁷⁰ 71ST ANNUAL REPORT, *supra* note 160, at 1.

¹⁷¹ *Id.*

¹⁷² 70TH ANNUAL REPORT, *supra* note 159, at 1.

¹⁷³ 71ST ANNUAL REPORT, *supra* note 160, at 1.

¹⁷⁴ *Id.* at 2.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *See id.* at Appendix E (containing a complete list of the amounts and categories of foreign origin products received in zones and subzones in 2009).

¹⁷⁸ *Id.*

¹⁷⁹ 71ST ANNUAL REPORT, *supra* note 160, at 2.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

portant to note that “about 58 percent of the shipments received at [FTZs] involved domestic status merchandise.”¹⁸⁰ This indicates that FTZ activity tends to involve domestic operations that combine foreign and domestic inputs.¹⁸¹

In 2009, the FTZ Board received and filed 60 formal applications requesting “authority for one new general-purpose zone and 14 subzones, as well as authorization for the expansion, reorganization, new manufacturing, and other changes at existing zone[s].”¹⁸² In addition, 104 cases involving routine changes to zone projects were processed under the FTZ Board’s less formal administrative procedures.¹⁸³

U.S. exports from general purpose zones and subzones have generally increased from 1989 to 2008, earning the U.S. a range of \$10 billion to \$40 billion.¹⁸⁴ However, in 2009, there was a marked decrease in U.S. exports from \$40 billion to around \$28 billion¹⁸⁵ due, in part, to the impact on trade of the global recession that began in 2008.

U.S. foreign trade zones can help U.S.-based manufacturers meet the challenges posed by globalization.¹⁸⁶ “Bilateral, regional, and global trade [agreements], and advances in global transportation and telecommunication [have managed] to lower the cost of introducing foreign-produced finished goods into the largest market in the world – the United States.”¹⁸⁷ This trend has negatively impacted the U.S. economy and U.S.-based manufacturers because of increased U.S. imports. In the transportation field, the development of containerization that began in 1970 enabled foreign produced goods to be transported quickly and efficiently to local distribution centers in the U.S.¹⁸⁸ In addition,

U.S. tariff rates that apply to imported goods have fallen significantly, [and] many new products are now eligible for duty-free importation into the United States. In 1970, roughly 65 percent of the total U.S. import value consisted of dutiable products, with Customs duties comprising 6.5 percent of the total value of all imports.¹⁸⁹

In 2005,

only 30 percent of total U.S. import value consisted of dutiable products, with Customs duties comprising only 1.4 percent of the total value of all imports... Multilateral tariff reductions such as the Tokyo Round of GATT and the Uruguay Round Agreements, [as well as] regional and bilateral trade initiatives...[and] the Generalized System of Preferences (GSP), the

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.* at 2. See also *id.* at Appendix F (listing zones requesting administrative actions).

¹⁸⁴ 71ST ANNUAL REPORT, *supra* note 160, at 4.

¹⁸⁵ See *id.*

¹⁸⁶ See Greg Jones, *U.S. Foreign-Trade Zones Help U.S.-Based Manufacturers Meet the Challenges Posed by Globalization*, FOREIGN-TRADE ZONE CORP. (June 23, 2009), <http://www.ftzcorp.com/ArticleDetails/tabid/210/ArticleID/7/Default.aspx>.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Caribbean Basin Economic Recovery Act (CBI), the U.S.-Israel Free Trade Area Agreement, the North American Free Trade Agreement (NAFTA), and the Andean Trade Preference Act have [arguably] all contributed to the lowering of tariff barriers into the U.S. market.¹⁹⁰

Despite the plethora of bilateral trade agreements and the fall in U.S. tariff rates, which have increased the importation of foreign products into the U.S., the use of foreign trade zones has grown significantly since the 1970s when there were only eight U.S. foreign trade zone projects in the U.S.¹⁹¹ Today, there are 277 zones and “more than 250 active special-purpose subzones.”¹⁹² The total “[z]one-related manufacturing activity exceeds \$400 billion annually.”¹⁹³

U.S. FTZs “enable companies to reduce or eliminate duties on products produced for domestic consumption.”¹⁹⁴ This is called the “tariff rate rationalization” benefit in the U.S. where the inverted tariff is eliminated.¹⁹⁵ “An inverted tariff relationship exists when the duty rate for an imported component or raw material is higher than that which would apply to an import of the finished product into which the component or raw material is incorporated.”¹⁹⁶ If the inverted tariff rate applies, the U.S.-based manufacturer would be better off moving manufacturing operations offshore.¹⁹⁷ Another solution to this problem is to move the U.S.-based manufacturer’s operation into an FTZ.¹⁹⁸

In addition to the tariff rate rationalization benefit for the U.S. manufacturer, there are other advantages to FTZs. An importer is exempted from paying duty on merchandise that is re-exported.¹⁹⁹ This benefit encourages the increase of U.S. exports.

Duty exemption or duty deferral also increases the manufacturer’s cash flow. No duty is assessed on domestic parts or materials or on domestic labor, overhead, or profit. No duty is charged when one vendor in a U.S. FTZ decides to transfer his goods to a purchasing company in another FTZ. Furthermore, no duty payment is required if merchandise does not enter into the U.S., or if it is defective or damaged. During the time the damaged items are tested, repaired, or stored in the FTZ, there is no duty charged. Merchandise may be altered, repackaged, and/or relabeled to meet various U.S. requirements. Zones are also used for properly marking the Country of Origin of the goods prior to their entry into the U.S.

The use of U.S. FTZs has been approved for a wide variety of manufacturing industries including the following products: electronics, computers, video and telecommunications equipment, plastics, food products, power tools and lawn care products, electronic business equipment, industrial and agricultural machinery, construction equipment, large and small

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *U.S. FTZ Program Use Grows*, *supra* note 100.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ See Dennis Puccinelli, *Foreign Trade Zones: US Customs Procedures & Requirements*, FOREIGN-TRADE ZONES BD., IMPORT ADMIN. (Feb. 2003), http://ia.ita.doc.gov/ftzpage/export_america.html.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

appliances, climate control equipment, medical equipment, chemicals and petrochemicals, automobiles and auto parts, pharmaceuticals, ships, and sporting goods.

Since FTZs in the U.S. can reduce costs for U.S.-based businesses and incentivize exportation of U.S. products, the FTZs may even help to keep factories open and maintain value-added economic activity in the U.S.

III. FREE TRADE ZONES OF THE WORLD

Free trade zones are growing in size and number across the globe. “[I]n 1986 the International Labor Organization’s ... data-base of SEZs reported [the establishment of] 176 zones in 47 countries; [and] by 2006, this number rose to 3,500 zones in 130 countries. [M]any of these zones are actually single companies licensed individually as free zones.”²⁰⁰ Nevertheless, SEZs “are estimated to account for more than US\$200 billion in global exports, and these zones employ directly at least 40 million workers.”²⁰¹ Thus, in over 130 countries of the world billions of dollars’ worth of goods are being transferred in free trade zones.²⁰² FTZs help to expand international trade, but they are also havens for illicit trade. Counterfeiting and money laundering can flourish in these zones.

Since 1970, the rapid growth and expansion of SEZs and EPZ programs all over the world has contributed to export-led growth in regions like East Asia.²⁰³ This “is due in part to an unprecedented globalization of trade and investment that took place since the 1970s and accelerated during the 1990s and 2000s.”²⁰⁴ But recent years have seen a shift away from the traditional EPZ model, which had a narrow focus, “toward the SEZ model, with emphasis on multiuse developments, physical, strategic, and financial links between the zones and local economies, a shift away from fiscal incentives to value added services, and a greater focus on differentiation through the investment climate in the zone.”²⁰⁵ Another more recent trend in free trade zones of the world is the growing importance of zones that are privately owned, developed, or operated, rather than publicly owned.²⁰⁶

A. Economic Performance and Impact of Free Trade Zones

The economic performance and impact of zone programs in developing countries have been evaluated in numerous studies according to a report of the World Bank published in 2008.²⁰⁷ Special economic zones are useful tools for economic growth and for the enhancement of industry competitiveness by attracting foreign direct investment.²⁰⁸ “Through SEZs, governments [can] develop and diversify [their] exports while maintaining protective

²⁰⁰ WB 2011 Report, *supra* note 2, at 5.

²⁰¹ *Id.*

²⁰² WB 2008 Report, *supra* note 6, at 7.

²⁰³ WB 2011 Report, *supra* note 2, at 5.

²⁰⁴ *Id.*

²⁰⁵ *Id.* at 6.

²⁰⁶ *Id.* at 7.

²⁰⁷ WB 2008 Report, *supra* note 6, at 3.

²⁰⁸ *Id.* at 1.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

barriers.”²⁰⁹ Governments can create jobs, pilot new policies in Customs, law, labor, and create public-private partnerships.²¹⁰ SEZs also enable governments to “supervis[e] enterprises, [and] provi[de] off-site infrastructure and environmental controls.”²¹¹ The World Bank Report in 2008 claims that “zones have been effective in addressing economic growth and development objectives, [but] they have not been uniformly successful.”²¹² East Asian and Latin American economic success with zones is not the same for other developing countries.²¹³ Many zones, particularly in Africa, have failed.²¹⁴ The impact of zones on employment (regarding gender, wage levels and benefits, worker rights and work conditions), as well as the environment and related social factors has raised concerns.²¹⁵

Since the 1980s zone development has increased dramatically, especially in Eastern and Central Europe, the Commonwealth of Independent States (CIS), and the Middle East and North Africa.²¹⁶ Nevertheless, zone activity is concentrated in less than a dozen countries which supply the majority of zone employment and generate the most exports.²¹⁷ Zones are concentrated in Asia and the Pacific (mainly China), Latin America, Central and Eastern Europe and Central Asia. “[M]ost zone enterprises worldwide are engaged in labor-intensive, assembly-oriented activities such as apparel, textiles, electrical and electronic goods ... Female workers account for 60–70 percent of the zone workforce worldwide.”²¹⁸

“The rationale for the development of special economic zones differs between developing and developed countries.”²¹⁹ The typical zone policy package “includes import and export duty exemptions, streamlined Customs and administrative controls and procedures, liberal foreign exchange policies, and income tax incentives,” all designed to boost an investment’s competitiveness and reduce business costs.²²⁰ Zones in developing countries support wider economic reform strategies, serve to alleviate growing unemployment, act as experimental laboratories for new policies and approaches to business, and attract foreign direct investment.²²¹

“The rationale for free trade zone development in industrialized countries is more varied.”²²² For example, the main rationale for the establishment and development of 22 zones in Japan is to promote foreign investment.²²³ “The main rationale for the Shannon Free Zone in Ireland, in contrast, is to establish a ‘growth pole’ in the economically distressed southern

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.* at 1-2.

²¹⁶ *Id.* at 2.

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.* at 12.

²²⁰ *Id.* at 12.

²²¹ *Id.*

²²² *Id.*

²²³ *Id.* at 13.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

part of the country. . . . [O]verall, enhancing trade efficiency and manufacturing competitiveness [is] the principal rationale behind . . . zone programs in most industrialized countries.”²²⁴

“There have been profound changes in the free [trade] zone concept and development since the first modern zone was established in Ireland in 1959.”²²⁵ Originally, the zones were isolated enclaves with access to incentives and privileges that were tightly controlled.²²⁶ Now zone development occurs countrywide rather than in restricted and remote areas.²²⁷ Originally, zones “were intended to promote exports, create jobs, and transfer technology through backward linkages.”²²⁸ Globalization and trade liberalization have changed that to a much broader goal. Zones are viewed now as a way to “promote two-way trade and facilitate liberalization and modernization of the host economy.”²²⁹ The integration of the zone into the domestic economy is a new trend.²³⁰

The economic benefits from zone development include the following: direct and indirect employment creation and income generation; export growth and export diversification; foreign exchange earnings; foreign direct investment, earning of government revenues, upgrading of employees skills, employment of females, increase in technology transfer, regional development, and “demonstration effect” arising from the application of “best practices” in the zones.²³¹

One of the key objectives for zones of the world is employment generation.²³² Zones

are viewed as highly effective tools for job generation, particularly for women first entering the workforce. Experience suggests, however, that the direct employment impact of zones is marginal. In most countries, zones are not a major source of employment. In fact, zones account for less than 1 percent of the global workforce, and are above 1 percent only in the Americas and the Middle East, and North Africa.²³³

However, there are indirect employment gains that are quite substantial and should be considered.²³⁴

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.* at 14.

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.* at 32.

²³² *Id.* at 34.

²³³ *Id.*

²³⁴ *Id.*

B. Specific Free Trade Zones of the World

1. China²³⁵

In keeping with its more receptive attitude toward the outside world since 1979, the People's Republic of China continues to try to emulate more advanced nations by establishing export processing zones. One such zone is at Shenzhen just north of Hong Kong's New Territories. "Special economic zones were established by China to serve as 'demonstration areas' for policy reforms and to encourage foreign investment. The economic impact of these free trade zones in China has been far-reaching, transforming entire regions and economies."²³⁶ Shenzhen has been transformed from a "small, sleepy fishing village into a thriving urban metropolis. Shenzhen is an export-oriented economy with an export value in 2003 of \$48 billion (14 percent of the national total), some \$30 billion in [foreign direct investment], and 3 million [people] directly employed."²³⁷ While the whole beautiful city is now a free trade zone, Shenzhen also includes a separately administered area named Shekou. A third free trade zone in China is being developed at Xiamen (Amoy Island), while the fourth is in the Zhuhai municipality near Macau, whose entire territory is a free zone. A fifth zone is at Shantou. These zones, which have attracted chiefly Chinese investors engaged in small processing and assembly operations, actually offer foreigners considerably more freedom than they have enjoyed up until now. Non-Chinese can own 100% of their own subsidiaries, sign long-term leases on land, set wages, and discharge incompetent workers who formerly held their jobs for life. Provisional regulations have been established for labor and wages, entry and exit, and so-called "Enterprise Registrations." More than 300 Hong Kong companies are engaged in manufacturing at Shenzhen, which is supplied with telephone service and power from Hong Kong. Generous tax and other incentives are available to attract foreign investment in the Special Economic Zones of Southern China, although some care must be taken to ensure that a special economic zone has the approval of the central government. China is conducting a campaign to close down hundreds of such zones which have not been authorized by the Chinese government.

China attempted to attract foreign direct investment by setting up SEZs, and this aim has been achieved with success. In fact, the Chinese economic boom may be due to their development of SEZs. In 1979, China established four SEZs in the southeastern coastal region of the country, and later added a fifth zone on Hainan Island.²³⁸ China patterned these zones "after similar zones [that were] established in Taiwan, the Republic of Korea, Singapore, and Hong Kong."²³⁹ "More than a hundred zones...now have been established around the country, offering low taxes and infrastructure at international standards."²⁴⁰ These zones are government run, and they have become one of the principal means by which the Chinese govern-

²³⁵ See WB Report 2011, *supra* note 2, at 69-125.

²³⁶ WB 2008 Report, *supra* note 6, at 29.

²³⁷ *Id.*

²³⁸ WB 2011 Report, *supra* note 2, at 70.

²³⁹ *Id.*

²⁴⁰ *Id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

ment provides preferential policies at the local, provincial and national levels, in order to foster the development of technology and industry.²⁴¹

China has also established overseas economic zones. In 2006, the Chinese government announced a new policy innovation to establish up to 50 overseas economic and trade cooperation zones.²⁴² Chinese companies had already ventured into the establishment of overseas industrial and trade zones in Egypt in 1999 in order to set up an industrial zone in the Suez economic area.²⁴³ Also in 1999 the Chinese appliance company Haier built its first industrial complex (a 46-hectare industrial park) in South Carolina.²⁴⁴ The Chinese government selected 19 overseas zone proposals across 15 countries for official support under its global policies of establishing overseas zones consisting of “science and technology parks, manufacturing and processing bases, or multiuse facilities.”²⁴⁵ The objectives of these overseas economic zones are to increase the demand for Chinese-made machinery and equipment and to facilitate the provision of post sales product support.²⁴⁶ “[B]y producing [products] overseas and exporting [them] to Europe or North America, Chinese companies [hope] to avoid trade frictions and [trade] barriers imposed on exports from China.”²⁴⁷ The zones have helped China “boost its own domestic restructuring and move up the value chain at home.”²⁴⁸ These overseas economic zones “were intended to create economies of scale for overseas investment and...to assist less experienced small...enterprises to venture overseas ‘in groups.’”²⁴⁹ The last objective was to transfer an element of China’s own success to other developing countries in order to benefit China ultimately by creating allies that trade with China.²⁵⁰

2. Russia

Russia has learned a lesson about the value of free trade zones from China. Russia has established special economic zones at Nakhodka, a Sea of Japan port, at Vyborg, and at Kuzbass in Siberia, on the Baltic Sea. With the dissolution of the Soviet Union in 1991 and the emergence of the Russian Republic as an autonomous entity, the development of the zone at Nakhodka has moved forward quickly, unimpeded by the need for central government approval. Inducements in Russian special economic zones are similar to those offered in Chinese zones. The Nakhodka zone offers a tax holiday for five years or until the zone venture shows a profit, with an eventual tax rate of 10%. The Russian Republic also signed a statute for a free economic zone in the Kuzbass coal region in Western Siberia.

In addition to free Customs duties, primary benefits of the special economic zones include the adoption of the tariff system, the payment of salaries in hard currencies, the establishment of joint enterprises in banking and insurance, and the creation of zone quotas for extracting and developing mineral resources. The entire Kuzbass region, which includes steel

²⁴¹ *Id.*

²⁴² *Id.* at 69.

²⁴³ *Id.* at 71.

²⁴⁴ *Id.* at 72.

²⁴⁵ *Id.*

²⁴⁶ *Id.* at 71.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

mills, chemical plants, and coal operations, has been designated as a free trade zone. A British coal consortium operates the first joint venture in the Kuzbass area, and it plans to export one million tons annually. The zone at Nakhodka is designed to step up trade with Japan and other Far Eastern countries. Nakhodka's zone includes the breakbulk Port of Nakhodka, the container-handling Port of Vostochny, the city of Nakhodka, and large systems of undeveloped land outside the city. A number of joint ventures, including American, Japanese, Korean, and Chinese firms, operate in Nakhodka. In St. Petersburg, plans call for using part of Japan's pledged \$2.5 billion in aid to develop a free enterprise zone. The city is becoming an enterprise hub, and there are already 350 foreign ventures there, 10% of which have United States partners. Competition for the Russian [z]one on the Baltic has become fierce as both St. Petersburg and Kaliningrad drew up plans for facilities. In 1991, President Yeltsin actually declared Kaliningrad a free economic zone. The greatest obstacles to free economic zones in Russia are legal in theory and practice. Although private land ownership in Russia is now legal, the ownership of land by foreigners is difficult to achieve in practice. Therefore, neither Nakhodka nor Kaliningrad can provide investors with sufficient inducements to construct facilities.

Other former Soviet Republics are following Russia's example. Ukraine is planning three free trade zones as part of its economic reform program. The 1993 Free Trade Zone Act was accompanied by two pieces of legislation, the Ukraine Law on Foreign Investment and the Law on Foreign Economic Activity. These laws include a five-year tax holiday for firms that are more than 20% foreign-owned, a five-year exemption from any new taxes imposed in the future, and a one-year exemption for enterprises with a foreign investment of from \$10,000 to \$50,000. Turkmenistan, one of the more progressive of the Commonwealth of Independent States, plans to establish seven free trade zones. Legislation entitles users to (1) a three-year tax holiday; (2) reduced rates on electricity, gas, and water; and (3) more liberal procedures for import and export operations. The zones will be designed especially to attract construction, food processing, research, and energy-intensive consumer industries. Kazakhstan, another member of the Commonwealth of Independent States, is establishing a free trade zone in Almaty.

Russia's recent accession to the WTO, obtained by agreement of the WTO members in December 2011 and ratified by Russia's own Parliament on July 10, 2012²⁵¹ (amid protests by more than 1000 Russian people), may have a significant impact on the functioning of the existing SEZs in Russia as well as the future establishment of more zones.

3. North Korea²⁵²

North Korea has followed the Chinese model by establishing "free economic and trade zones" at Najin and Sonbong in the northeastern province of Hamgyong on the Sea of Japan near the Chinese border. Companies in these zones operate as foreign equity joint ventures or as 100% wholly foreign owned corporations. In addition, Najin and Sonbong ports and Chongjin port and the adjacent area are free trade ports.

²⁵¹ Press Release, World Trade Org., Lamy Hails Russia's WTO Accession Ratification (July 23, 2012), *available at* http://www.wto.org/english/news_e/pres12_e/pr668_e.htm.

²⁵² See James P. Bell, *Korean Unification*, DEF. TECHNICAL INFO. CTR. (1995), <http://www.dtic.mil/dtic/tr/fulltext/u2/a300182.pdf>.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

North Korea wanted to break out of the economic isolation that followed the loss of its main markets when Communism collapsed in the Soviet Union in 1991. North Korea then said it would guarantee foreign investments in these zones, cut or eliminate duties, and encourage co-production and joint ventures with domestic industry.

Under North Korea's 1993 Law on Free Economic and Trade Zones, foreign-funded enterprises operating in the free economic and trade zones enjoy a reduction on business income tax from 25% to 14% (10% for high technology, infrastructure, scientific research, and technical development) and from 20% to 10% on dividends, royalties, rents, interest, and other passive income. Under the law on foreign-invested banks, which was approved by the Democratic People's Republic of Korea Standing Committee of the Supreme People's Assembly on November 24, 1993, foreign investors may establish and operate joint-venture banks and branches only in the free economic and trading zone established along the Tumen River on North Korea's northern border with China and Russia. Foreign banks may deposit and invest in foreign currencies, give guarantees in respect of foreign currency liabilities and defaults on contractual obligations, and process importers' and exporters' bills as well as accept securities in foreign currencies.²⁵³

4. Japan²⁵⁴

Japan's Cabinet and Parliament passed a bill to establish "foreign access zones" on Japanese soil to aid exporters to Japan. Preferential loan rates and tax incentives are offered to recently-formed Japanese subsidiaries of overseas companies, which process imports using simplified Customs procedures through bonded facilities located near Japan's major cities. Government funding for the projects is included in marketing studies for foreign companies in Japan. Initially, 18 of these foreign access zones were established throughout Japan in 1993–1995. Altogether 31 zones are envisaged by the legislation, whose implementing regulations were published in the summer of 1992. Market research and pre-development activities for the zones themselves were funded in the 1992–1993 budget. The zones are located near airports and harbors, and they are established under the guidance of the Ministry of Industry and Trade Administration (MITI) and the Ministry of Transport. The zones are equipped with the most modern cargo sorting and storage facilities as well as import-related information, design and display centers. The first six zones approved were: Osaka (2), Kobe, Ehime, Kitakyushu, and Nagasaki. Other areas under consideration are Yokohama, Kawasaki, Hiroshima, Shimonoseki, and Oita.

5. Vietnam²⁵⁵

As part of Vietnam's program to attract foreign capital, the Government constructed two export processing zones at Tan Thuan, a 750-acre site on a bend in the Saigon River, and

²⁵³ See generally Eric Yong-Joong Lee, *The Special Economic Zones and North Korean Economic Reform with a Viewpoint of International Law*, 4 FORDHAM INT'L L.J. 5, 27 (2003).

²⁵⁴ See generally *Japan Business – FAQ's*, RUSSTHAI (2012), http://home.swipnet.se/~w-10652/Japan_business_FAQ_1.html#top.

²⁵⁵ See generally *Export Processing Zones and Industrial Zones*, DEP'T OF PLANNING & INV. (2001), <http://www.dpi.hochiminhcity.gov.vn/invest/html/pre1.html#1>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

at Ho Chi Minh City (formerly Saigon). The Tan Thuan EPZ includes the Port of Ben Nghe and is a joint venture with the Central Trading Development Corporation. The Ho Chi Minh EPZ is about ten miles from the city center and is a joint venture with Hong Kong investors who have worked with China's largest Special Economic Zone at Shenzhen. More than 40 foreign companies built facilities at the Ho Chi Minh City EPZ. Manufacturers in the zones pay a reduced rate of 10% tax compared with the normal 15% rate outside the zones; moreover, they are granted a four-year tax holiday from the first profitable year.

A consortium consisting of a number of Malaysia's largest public firms known as Malaysian South-South Corp. established an export processing zone in Vietnam. The zone serves as a base for Malaysians to invest in the industrial sector of Vietnam. Plans include development of land totaling 741 acres in Da Nang in a joint venture of Malaysian South-South Corp. and Vietnam's Quangnam Danang Export Processing Zone Development Corp., at a cost of around \$150 million. Da Nang is a former United States naval base that has landing strips accommodating large airplanes.

6. Cambodia²⁵⁶

A special tourism zone in Siem Reap Province with a luxury hotel, other hotels, and a commercial center was established in 1997, and other zones in Phnom Penh and Sihanoukville have been completed and developed.

7. Cyprus²⁵⁷

Another unusual zone development has taken place on the island of Cyprus. The government's efforts to get two free trade zones established was helped when the national airline, Cyprus Airways, commissioned a feasibility study that was completed in 1981. The Larnaca zone started operating in 1983, following port expansion, and was granted special Customs treatment characteristic of virtually all free trade zones. Cyprus established this free trade zone to attract industry from overseas that might have gone elsewhere if it had not had such a facility. Moreover, Cyprus created this free trade zone to promote its own exports.

8. Africa²⁵⁸

In North Africa, SEZs have played a significant role in catalyzing export-oriented diversification in Egypt, Morocco, and the United Arab Emirates.²⁵⁹ "[I]n Sub-Saharan Africa, Mauritius is an example of [a country with] zones operating as a central policy tool sup-

²⁵⁶ See generally Lionel Bécherel, *An Ecotourism Development Model for Cambodia an Initiative in Peam Krasop Wildlife Sanctuary*, MEKONG TOURISM COORDINATING OFFICE (April 2008), <http://mekongtourism.org/website/wp-content/uploads/downloads/2011/02/An-Ecotourism-Development-Model-for-Cambodia-Group-Develop.pdf>.

²⁵⁷ See generally *Larnaca Trade Zone*, CYPRUS TRADE CTR. (2005), <http://www.ctcdubai.org/index1.asp?cid=4>.

²⁵⁸ See generally GRAHAM GLENDAY & DAVID NDII, *EXPORT PLATFORMS IN KENYA* (2000), available at <http://www.cid.harvard.edu/hiid/752.pdf>.

²⁵⁹ WB 2011 Report, *supra* note 2, at 5.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

porting a highly successful process of economic diversification and industrialization.”²⁶⁰ China has attempted to set up SEZs in Africa, but “the authority [in Africa] responsible for developing, promoting, and regulating the program lacks resources and capacity to carry out its mandate.”²⁶¹ In Africa, most zone initiatives have been failures, except for Mauritius, Kenya, Lesotho, and Madagascar.²⁶² Malawi, Sierra Leone,²⁶³ Ghana,²⁶⁴ Nigeria,²⁶⁵ and Seychilles²⁶⁶ all have free zone laws.

9. Kenya

As an example of the developing nations’ hopes in Africa, Kenya has approved legislation that allows companies operating in export processing zones to deduct the total cost of replacing or expanding capital equipment after the first ten-year period of operations, during which no corporation tax is levied. In Kenya, six export processing zones are to be developed, but only one is presently in operation at Sameer Industrial Park. The latter and two others planned for Thika and Nakuru will be privately owned. Three government-owned zones are projected for a 4,000-acre site on the Athi River near Nairobi, a 1,300-acre site at Miritini west of Mombasa, and a site in Likoni south of Mombasa. The Athi River zone was scheduled to be operational in 1993, and the plans were to gradually transfer the control and operation of the zone into private hands. Meanwhile, Kenya has a Manufacture-Under-Bond (MUB) arrangement that is applicable anywhere in the country and offers a 100% rebate of taxes and duties on imported equipment and raw materials if they are used exclusively for the production of products for export.²⁶⁷

10. Gambia²⁶⁸

Gambia approved an industrial free zone law in 2001 providing for an exemption from income tax and Customs duties.

²⁶⁰ *Id.*

²⁶¹ *Id.* at 12.

²⁶² *Id.* at 11.

²⁶³ See UNITED NATIONS CONFERENCE ON TRADE & DEV., INVESTMENT POLICY REVIEW: SIERRA LEONE, at 32, U.N. Sales No. E.10.11.D.8 (2010).

²⁶⁴ See Ghana Free Zone Act of 2001 (Act No. 504) §§ 28-29 (Feb. 22, 1996), available at <http://www.ilo.org/dyn/natlex/docs/WBTEXT/42005/64978/E95GHA01.htm>.

²⁶⁵ See *The Nigerian Export Processing Zones Scheme*, ONLINE NIGERIA, <http://www.onlinenigeria.com/agriculture/?blurb=483> (last visited Nov. 14, 2012).

²⁶⁶ See THE SEYCHELLES INT’L BUS. AUTH., <http://www.siba.net/> (last visited Nov. 14, 2012).

²⁶⁷ See *Kenya’s Investment Environment*, KENYA EXP. PROMOTIONS COUNCIL, http://epckkenya.org/index.php?option=com_content&task=view&id=77&Itemid=87 (last visited Nov. 14, 2012).

²⁶⁸ See Gambia Free Zone Act 2001, available at http://www.vertic.org/media/National%20Legislation/Gambia/GM_Gambia_Free_Zones_Act.pdf.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

11. Burundi²⁶⁹

Burundi is attempting to attract investment and increase foreign-exchange earnings by developing a free-trade zone arrangement that applies to the entire country, providing a ten-year exemption from taxes on profits and other incentives to local and foreign-owned companies that produce non-traditional goods entirely for export.

12. Algeria²⁷⁰

In Northern Africa, Algeria approved free trade zone legislation in 1993, with a number of zones planned in the port regions. Under the Algerian Investment Code of October 10, 1993, all investments made in Algerian free trade zones are in foreign currency, and when production of goods and services is exported, they are exempt from all taxes except those on certain tourist vehicles. Investors in the free trade zones may sell part of their production locally. Foreign personnel employed in Algerian zones are subject to a reduced tax rate of 20%.

13. Middle East²⁷¹

Free trade zones in the Middle East are thriving in the United Arab Emirates, and especially in Dubai.

14. Central America²⁷²

Cuba has entered the free trade zone market. The largest zone set to open is at Mariel, a municipality and city in the Artemisa Province of Cuba.²⁷³ The west side of the bay is a former submarine base which was designated as a free trade zone, 60 km. west of Havana.²⁷⁴

IV. FREE TRADE ZONES AND THEIR SERVICES

Generally, all facilities allow entry of raw materials, components and finished goods of foreign origin and subsequent re-export without being subjected to customs duties. In many zones foreign traders may warehouse, manufacture, process, label or package goods without the host nation applying its tariffs or import controls on the merchandise in the zone. Customs duties are levied, and import controls are applied only when the foreign goods are removed from a free trade zone for use or consumption in the country where it is located.

²⁶⁹ See TAX JUSTICE NETWORK-AFRICA & ACTIONAID INT'L, TAX COMPETITION IN EAST AFRICA: A RACE TO THE BOTTOM? 3, 7 (2012), available at www.actionaidusa.org/sites/files/actionaid/eac_report.pdf.

²⁷⁰ See generally Omar T. Mohammedi, *International Trade and Investment in Algeria: an Overview*, 18 MICH. J. INT'L L. 375 (2010).

²⁷¹ See generally KPMG, INVESTMENT IN THE UNITED ARAB EMIRATES (2006), available at <http://www.kpmg.com/cn/en/issuesandinsights/articlespublications/pages/inv-uae-o-200611.aspx>.

²⁷² See generally Marc M. Harris, *Cuban Free Trade Zones (1997)*, <http://cubaninvesting.tripod.com/cubantradezones.html> (last visited Nov. 14, 2012).

²⁷³ See *Brazil Offers Legal Assistance for Free Trade Zone*, CUBASTANDARD.COM (Aug. 21, 2012, 11:27 AM), <http://www.cubastandard.com/2012/08/31/brazil-offers-legal-assistance-for-free-trade-zone/>.

²⁷⁴ See Harris, *supra* note 272.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

Customs-privileged facilities consist of five basic categories with which importers, exporters, manufacturers, processors, and assembly operators should be familiar: (1) free trade zones; (2) free ports; (3) transit zones; (4) free perimeters; and (5) special types of facilities. Of these, the *free trade zone* is best known and most frequently used. A free trade zone is always free of customs duties and import controls. Some guarantee the users complete income tax exemption. Others grant concessions only on goods processed or manufactured for export. Goods brought into these facilities need not be declared as customs entries into the host country. The payment of a bond or security is not normally required. The Colon Free Zone of Panama and the Shannon Industrial Free Zone are two of the most successful free trade zones, but they have two different objectives. The former concentrates on warehousing, the latter on export processing.

Few restrictions usually are imposed on the type of goods in a free trade zone. Upon introduction into a free zone, the goods become eligible for any applicable export incentive, tax refund, or drawback payment. Generally, there is no limit on how long the goods may remain in a zone. Arrangements for using a zone for freight forwarding purposes are made regularly. Importation, processing, or private ownership of gold is prohibited in the United States foreign trade zones, but there are no restrictions on silver operations.²⁷⁵

In recent years, a number of developing countries have approved legislation that introduces the free port system by adopting legislation designed to attract foreign capital. As examples, Djibouti and Togo in Africa, Gibraltar in Europe, and Fiji in the Pacific have adopted laws that make their entire area free ports by avoiding duties on imports.

The *transit zone*, sometimes called “free zone” or “free transit zone,” is a port entry in a coastal country, which serves as a storage and distribution center. Generally, it is created to facilitate free transit of goods to a neighboring land-locked country. Goods in transit to and from the neighboring country are not subject to customs duties, import controls, and other formalities. The transit zone is more limited than the free trade zone or the free port, sometimes consisting only of one warehouse in the port area. Processing operations are usually not permitted and storage time may be limited. The Bangkok Transit Zone is one of the best known and most successful. In a few countries, a transit zone is called a *free storage area*, as in Chile, where there are ten used for warehousing and transshipment of goods.

A *free perimeter* is similar to a free port, but usually is confined to a remote or undeveloped region of a country. Free perimeters function primarily to serve local consumption. Tariffs are likely to be reduced, not exempted, and free perimeters often handle only specific imports, such as foodstuffs or pharmaceuticals.

Special customs privileges are available in certain industrialized nations that do not operate bona fide free trade zones. Customs duty exemption and minimal customs formalities are characteristic of these privileges. The special customs-privileged facility is usually designed to permit temporary entry of foreign goods for re-export or prior to dispatch of goods into a local market. However, processing, assembly or manufacturing operations may be possible. Arica in northern Chile is a good example.

A few industrial countries permit private companies to operate their own customs-free zones under specific government laws. For instance, in Belgium and the Netherlands, it is a relatively simple matter for a company to fence off a piece of property adjacent to its manu-

²⁷⁵ See U.S. Foreign-Trade Zones Board, Order No. 4 (Amended), An Order Relative to the Handling of Gold in Foreign-Trade Zones (Feb. 6, 1939), available at <http://ia.ita.doc.gov/ftzpage/fr/general/o4.html>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

facturing, processing or trading operation and to have it declared a free zone. Customs agents generally inspect the enclosed area once a month or once a quarter and check inventories for entry or exit of goods.

Although the Netherlands does not have any free trade zones *per se* as officially designated by the government, it does permit customs-bonded warehouses adjacent to or near existing plant operations. Schiphol, Amsterdam's international airport, has 15,130 square meters of former warehouse space converted into bonded facilities at the east end of the airport. However, these are strictly transshipment facilities for imports and exports, and they are nothing more than Customs-bonded warehouses.

V. FREE TRADE ZONES AND THE EUROPEAN UNION

After many years of controversy concerning the establishment and use of free trade zones in the European Union, the EC Council finally in July, 1988 issued Council Regulation (EEC) 2503/88 on Customs warehouses. EC Council Regulation (EEC) 2504/88 on free zones and free warehouses was also issued in 1988. At that time, the approval of these regulations legitimized such old existing free trade zones as those in former West Germany, Ireland, Italy, Spain, and to the post-EEC Treaty of Rome zones more recently established in France and the United Kingdom. A Committee on Customs Warehouses and Free Zones was established to oversee the harmonization of free trade zone and free warehouse regulations throughout the European Union.

European Union goods stored in a Customs warehouse are now deemed to be exported products. The rules also state that free zones and free warehouses are "zones or premises," respectively, within the EU Customs Territory in which non-EU goods are placed, and they are not considered imported goods. Thus, any EU goods placed in a free warehouse or free zone are deemed to be exported. Free warehouses and free zones do not fall under the supervision of Customs authorities. Moreover, Customs formalities are simpler in the free trade zones than in the other areas of the EU Customs Territory.

VI. MAJOR BUSINESS BENEFITS OF FREE TRADE ZONES

Today's version of the customs duty-free zone offers many more advantages to businesspeople than were ever dreamed of in ancient and medieval times. As an example, the New York Foreign Trade Zone No. 1 boasts of thirty-odd services, which range from the traditional operations of warehousing, labeling, packaging and sorting to the more sophisticated services of assembly, processing, manufacturing or re-exporting. Here are some of the specific business benefits derived from using a free trade zone:

A. No Customs Formalities

Goods imported from all corners of the globe are landed and stored quickly without the usual customs formalities. In addition to the traditional duty-free entry from customs, the quota restrictions or bonding regulations of the host country generally are not applicable in the zone. As an example, dozens of New York harbor's piers are adjacent to the New York Foreign Trade Zone, so that merchandise may be transferred from ocean-going vessels to the

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

zone's warehouses in a matter of minutes. Thus, goods quickly enter the United States without the application of quotas, Customs levies, or time-consuming Customs formalities.

B. Improved Cash Flow²⁷⁶

Companies using free trade zones can improve their cash flow substantially, especially in times of tight money conditions as experienced in recent years. Since Customs duties are not payable while goods are in the zone or at all, if they are exported, this advantage provides available cash. Only when the merchandise is brought into the country of the same location as the zone (*i.e.* not exported but consumed locally) is it necessary to pay the import duties.

Goods may be withdrawn from the zone, at the discretion of the owner, in smaller than case lots or in other partial amounts. On the other hand, when goods normally enter into a Customs Territory, there is an eight-day limit from the date of arrival for declaration of the merchandise. Some Customs officers are located in the free trade zone and others are assigned to the bonded warehouse so that there are no delays in obtaining Customs declarations when required. Under United States laws, inventories in bonded warehouses must be declared and periodically inspected by Customs officers.

C. Owner Access to Merchandise

Imported goods located in free trade zones are not considered to be under Customs custody, although they may be under continuous surveillance. Therefore, the owner has complete access to the merchandise at any time, and he may utilize warehouse receipts for bank loans, assignments of title, or for other collateral. A number of United States and foreign banks accept these warehouse receipts regularly against merchandise stored in a free trade zone.

D. Showroom Space Available

Since title of the merchandise remains with the seller while in a zone, many companies make use of available space as a showroom. For example, at the New York Foreign Trade Zone, this showroom service is becoming an important aid in boosting sales for American and foreign enterprises that do not have selling facilities in the New York area or on the east coast. Buyers may inspect, and even sample, goods displayed in the zone showroom before purchase, or before payment of duty, if sold to domestic businesses. One of Europe's leading heavy machinery producers makes continued use of the zone to display various machines in its showroom located on the zone premises. There is wide acceptance by United States users of this method of showroom sales, where potential importers may visit and examine machinery closely. Many multinational companies continually use free trade zones for showroom purposes. Practically all of these overseas firms claim that, without a showroom, they would never have been able to capture such a large share of a local market. Barcelona, Copenhagen, Helsinki, and Vienna are other typical examples of showroom display zones.

²⁷⁶ See *U.S. FTZ Program Grows*, *supra* note 100.

E. Accounting Advantages

Because invoices are not completed until the goods are sold, the zone user who holds title to the merchandise while on display does not have to show the sale in his books until it is actually made. This may mean postponement of taxes to a more convenient taxable year for reporting the earnings. Moreover, the orders may be accepted in the zone before payment of either the import duty, or the excise tax, if one should be applicable.

F. Reduced Insurance and Duty Costs²⁷⁷

Savings on insurance premiums for goods in storage [in the zone] can be considerable. The cost of insurance is limited to the value of the warehoused goods, plus the ocean freight charges, rather than computed on these two costs plus duties and taxes paid. Zone users throughout the world buy piece material at auctions in the Far East or Europe, but they do not know the exact quantity of their purchases. When the shipment later arrives in a zone, the amount is verified in order to determine the cost of Customs duty based on the goods that are actually brought into the host country. By measuring the quantity and then paying duty, both insurance costs and duty charges can be reduced.

G. Assembly of Domestic with Foreign Goods²⁷⁸

Assembling of imported goods with domestic or with other imported components is one of the principal functions of a free trade zone. Among the leading commodities brought in for assembly in a free trade zone are watch movements, which are placed in watch cases manufactured both in the country of location or abroad. After the watches are assembled, a sizable portion of the assembled output is sold for domestic consumption and the remainder is re-exported. This type of operation reduces the cost of the product to the local consumer by avoiding duties on the domestic components, while also contributing to the trade balance of the country. A foreign company can bring goods into a United States zone, "Americanize" them by processing and adding components, then export the goods without paying taxes on the imported merchandise. In some cases, it is possible to put a "Made in U.S.A." label on the finished product. A similar operation handled in a zone is the importation of camera lenses which, when assembled with the domestically made body of the camera, affords a dollar savings to the buyer and reduces the cost of the re-export by avoiding Customs duties on the lens.

H. Ideal Manufacture Location of Goods

Many zones offer an ideal location for almost any type of manufacturing. One of the key issues facing the U.S. economy today is the need to bring back the manufacturing we

²⁷⁷ See generally *Foreign Trade Zone (FTZ) #220*, SOUTH DAKOTA PORT USA §§ 5, 21, <http://www.internationalportinfo.com/services/foreigntradezone#ftz2> (last visited Nov. 14, 2012). See also Tiefenbrun, *supra* note 1, at 695-696.

²⁷⁸ See generally George Hanks & Lucinda Van Alst, *Foreign Trade Zones*, 80 MGMT. ACCT. USA 20, 20-23 (1999).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

lost through excessive outsourcing. FTZs enable U.S. entrepreneurs to manufacture more easily and with lower costs to the business.

When products are manufactured in a zone, the duty rate or quota limitation on the finished product entering the host country's trade channels may be applied to the finished product. As an example, only the percentage which is of foreign origin, or the actual foreign materials represented in the final product, are subject to the duties and quotas. For example, in the New York Foreign Trade Zone, a major New England manufacturer of machinery imports various sample machines from Europe, inspects the equipment, and gives it a trial test in the zone. Only after the firm is satisfied that the machine fulfills its requirements does the company initiate a plant operation in the zone. In the Shannon Industrial Free Zone, most users assemble or manufacture goods for export into the European Union or to the United States.

I. Processing or Manipulation of Goods

Goods may be processed or manipulated in a zone in order to qualify for the lowest possible duties or freight charges. This type of operation may involve food processing or canning, product rehabilitation, reconditioning, or waste elimination. Dozens of major food processors across the United States and abroad traditionally have banked on foreign trade zones to can their fruits, vegetables, and fish products. At the New Orleans and Honolulu foreign trade zones, refrigerated produce plays a vital role in their operation. The New York Foreign Trade Zone has a sizable refrigerated area where subfreezing temperatures are constantly available. It is here that large quantities of caviar are stored for periods from two weeks to two months before being re-exported to many countries of the world. The incoming bulk caviar is packed in small cans in the zone and then shipped in cases. In Salonika, Greece, a used-machinery dealer imports old equipment from abroad, stores it in the free trade zone until it is reconditioned and then re-exports the rehabilitated machinery to new buyers in Africa and the Middle East. Lower duties are then paid on the processed goods.

J. Packing, Repacking, and Labeling²⁷⁹

Free trade zones historically have attracted international traders for the convenient packaging, repackaging and labeling services provided. The Panama Colon Free Trade Zone is well known for these services. Goods in the zone may be altered, labeled, re-labeled, or re-marked to meet federal or local requirements or to avoid penalties for failure to mark merchandise properly. Moreover, samples may be withdrawn to submit to Customs for proper classification in order to eliminate incorrect labeling and delays in shipments. A multinational Japanese electronics firm makes profitable use of the Colon Free Zone by importing a wide line of products, removing superfluous packaging material and re-exporting electronic items. However, since the re-packaged product has lost both weight and cubic footage, it is then re-shipped by air from Panama to its destination at considerable savings in time and money.

²⁷⁹ See generally *Operations in the Colon Free Trade Zone*, BUS. PANAMA, <http://www.businesspanama.com/investing/opportunities/cfz.php> (last visited Nov. 14, 2012).

K. Easy to Discard Goods

Free trade zones encourage further savings from duty charges because users can discard substandard goods before application of tariffs. Many importers have found that shrinkage, evaporation, seepage, damage or accountable loss can cut profit margins sharply. A manufacturer who has developed a scrap business with a 20% to 30% rejection rate benefits considerably from a foreign trade zone operation because he pays duty only on the residual scrap. By using a free trade zone, the owners of merchandise are not forced to wait to apply for duty refunds after removal of goods, as they do when they are confronted with these misfortunes in a customs territory. For example, edible nuts imported from Brazil, India, and other countries are stored in zones until they dry out. Subsequently, they may be presented to Customs for payment of duties at a reduced rate since the water originally contained in the nuts has evaporated so that the product weighs less.

L. Wide Variety of Products Handled

Among the numerous products involved in the manipulation and manufacturing operations of many free trade zones throughout the world are essential oils, leather, radio and television sets, scarves, watch bands, umbrellas, automotive parts, handicrafts, ship stores, car cassettes, watches, cameras, machine tools, chemicals, and pharmaceuticals. At one time, more than 60% of all the pharmaceuticals entering Argentina were processed and packaged in Panama's Colon Free Trade Zone and flown out of Panama's Tocumen Airport. Many types of industries frequently depend upon free trade zones, particularly clock assembly, machine tool packaging, automotive equipment testing, highly specialized electronics assembly, processing of fish and other foods, and chemical and pharmaceutical mixing and labeling for re-export. For example, unmounted optical lenses might be subject to an 8.5% duty, as compared to 11% for mounted lenses. In addition, components for small trucks might be charged duty at a 3% to 4% rate, while assembled small trucks have a 25% tariff.

VII. SOME PRACTICAL ASPECTS OF USING A FOREIGN TRADE ZONE IN THE UNITED STATES OR A FREE TRADE ZONE IN THE WORLD

Goods in excess of host country import quotas may be brought in and held at the zone until the next quota period because there is no time pressure to move products out of a zone.²⁸⁰ Import quotas do not apply in most free trade zones. However, frequently in some zones around the world it is necessary to ship the merchandise into a Customs Territory simply because warehouse space is limited. For example, of the 960,000 square feet of all concrete warehouse space available at the New York Foreign Trade Zone, approximately 95% is already being used.

Merchandise subject to quotas may be imported into a free trade zone and manufactured into a product for which there are no quota limitations. When salvage or repair work is

²⁸⁰ See U.S. CUSTOMS & BORDER PROT., FOREIGN TRADE ZONES: U.S. CUSTOMS PROCEDURES AND REQUIREMENTS (2008), available at <http://ia.ita.doc.gov/ftzpage/customsftz.html> [hereinafter, U.S. CUSTOMS PROCEDURES AND REQUIREMENTS].

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

done, it is important that the host government and labor cooperate in providing companies with specialists who can modify or change a product into a non-quota item.

The United States Treasury amended the Customs Regulations so that overhead and labor costs are excluded from the dutiable value of goods assembled, manufactured, or manipulated in the United States foreign trade zones. Profits are also excluded. Tenants who manufacture or assemble in a zone such products as automobiles and motorcycles are subject to a lower tariff on the end product.

Transfer of bonded merchandise may be expeditiously handled at free trade zones because Customs Officers are located on the spot. Thus, goods may be exported with a minimum of delay. In this way, the foreign trader is able to benefit from immediate recovery of taxes previously paid when the bond was cancelled or when the time limit applicable to a bonded warehouse has expired.

Because of the easy availability of Customs Officers located at free trade zones, prompt recovery of duties or state taxes paid may be obtained when merchandise is entered into the zone for exportation at a later date.

Prior to 1976, foreign goods brought into the United States were exempt from local taxes as long as they remained in their original packages. In a far-reaching decision, the U.S. Supreme Court then allowed states to tax imported goods in the *Michelin Tire Corp. case*.²⁸¹ Subsequently, the California Court of Appeals struck down the state's law, providing that such laws discriminate against interstate commerce by not granting similar exemptions to all goods stored for trans-shipment.²⁸² California lifted its taxes on all inventories in response to the State Court's ruling, while 36 other states have free port statutes treating foreign goods more favorably than locally produced items. As a result, the U.S. Supreme Court has agreed to determine the fate of state free port laws.

A. Protection Against Theft

In view of Customs security supervision, goods stored or warehoused in a foreign trade zone in the United States have added protection against theft. Moreover, at the New York foreign trade zone, the city of New York provides a 24-hour foot patrol, and only authorized persons are permitted into the fenced-off area of the Brooklyn Navy Yard. The main building housing the foreign trade zone consists of 16 floors hooked up to a central police station burglary alarm system. Building security also encompasses a central station sprinkler system directly tied to the New York City Fire Department.

An integral part of a zone's security system usually is the bank-type steel vaults covering a large area for highly valuable storage items. These vaults should be awarded an underwriters' laboratory or engineering rating wherever possible.

Posting of a bond for missing documents may be avoided at U.S. foreign trade zones if merchandise is held on the premises as long as required until the documents are located or

²⁸¹ *Michelin Tire Corp. v. Wages*, 96 S. Ct. 535, 548 (1976) (holding that non-discriminatory state taxation of imported goods which had been mingled with other goods, stored and arranged for sale was not prohibited by the Constitution).

²⁸² *Star-Kist Foods, Inc. v. County of Los Angeles*, 42 Cal.3d 1 (1986) (striking down § 225 of the California Revenue and Tax Code, which exempted imported goods from taxation. The exemption was held to discriminate against taxed non-imported goods).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

until new ones are obtained. In some zones, this has become a problem when goods must be moved under time limitations or when crowded space forces relocation of imports.

Unlimited periods of storage are allowed in free trade zones in order to avoid pressure to move goods. This offers foreign traders considerable flexibility in delivery dates and encourages them to seek out the best markets or wait for the most propitious market conditions. When domestic buyers are unreceptive to a particular product, zone users have the added benefit of the option to ship elsewhere. Giant elevators usually are built in zones to move out warehoused merchandise on same-day instructions if documents are in order. A zone's facilities generally are designed to handle products for any type of industry.

Goods may be moved from a zone by huge overhead cranes to alongside quays located on both sides of incoming or outgoing warehouse buildings. Ample and modern equipment with a sufficient number of quays is available to move all kinds of merchandise in most zones constructed in the past few decades.

Because most U.S. foreign trade zones boast of highly mechanized operations, the officers and staff of each zone can maintain a close watch on day-to-day activities. Both management and the management board usually are directly involved with daily transactions.

B. Helps Trade Balance

A free trade zone, instead of creating imports, encourages exports and the final processing of foreign goods in the host country. Many of the items processed represent original shipments from a foreign nation that do not enter the mainstream of international commerce as an export until they are altered or completed in the zone. According to the United States Foreign Trade Zones Board in Washington, "domestic labor, facilities, materials and components can be used at least to some extent on articles that might otherwise have been imported as completely finished products ready for final sale."²⁸³ Thus, the free trade zone is continually making a vital contribution to the trade balance of the country in which it is located by helping to cut down on certain imports. On the other hand, when the United States dollar is strong, this has a dampening effect on American exports and forces some United States multinational corporations to shift their production from United States zones to those located overseas. Not only are dollar costs lowered when manufacturing is done abroad, but more competitive pricing allows hard-pressed American companies to maintain their world markets.

In view of the many developing nations' concerns over their balance of payments deficit and the economy, manufacturing operations in a zone must be investigated by proper authorities in advance to determine their impact on both. Specific government rules or policies, including any import regulations that may be affected, also should be examined in relation to the proposed manufacturing.

²⁸³ See Ward Poche, *Stewart Trade Zone Eyed by Interim Study Group*, THE EVENING NEWS (N.Y.), Aug. 18, 1975, at 4A, available at <http://news.google.com/newspapers?nid=1982&dat=19750818&id=pk5RAAAIBAJ&sjid=6jMNAAAAIBAJ&pg=1174,2436661>).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

C. Typical Processing Transaction²⁸⁴

Here is a typical transaction in processing merchandise in one of the 3,500 free trade zones throughout the world and the 277 foreign trade zones in the United States.²⁸⁵ After advising the management of a zone of the quantity and expected date of arrival of a shipment, the consignee, his agent or Customs house broker prepares an application in sextuplicate to store in the zone. Known as a Concurrence Form, this application is presented to the delivering carrier for its releasing signature.²⁸⁶ After the application is presented to the zone's management for "concurrence," it is then presented to Customs for numbering and issuance of a Customs Permit to transfer across Customs Territory, if this is necessary.²⁸⁷ However, arrangements to transfer merchandise to the zone are the responsibility of the owner of the merchandise.

In order to withdraw merchandise from the zone, the Pier Office will prepare a Constructive Transfer Form C upon notice of intent to the zone by the owner and after securing the necessary Customs Concurrence.²⁸⁸ Copies are forwarded to the consignee who uses them as a bill of lading for presentation to the Customs House while filing the export or import documents.

When goods are received at the zone, a nonnegotiable receipt is sent to the user, along with the invoice for the first month's storage and handling charges. Upon request, a negotiable warehouse receipt will be issued which is acceptable for trading or financing purposes.²⁸⁹

D. Tax Treatment Favorable for Zone Users

One of the great advantages of using a foreign trade zone is the avoidance of double taxation. This is particularly true in the United States where the world's leading fabric houses and industrial manufacturers rely on impressive showrooms to display apparel or machinery. More than 1,800 income tax treaties are in effect among more than 160 countries to avoid double taxation.²⁹⁰ The policy of not taxing enterprises displaying merchandise for showroom purposes in a host country originally was recommended in the Model Income Tax Convention drafted by the Organization for Economic Cooperation and Development (OECD) in 1956

²⁸⁴ See U.S. CUSTOMS & BORDER PROT., FOREIGN-TRADE ZONES MANUAL 19 (2011) [hereinafter FOREIGN-TRADE ZONES MANUAL].

²⁸⁵ See also WB 2011 Report, *supra* note 2, at 5 (citing "3,500 zones in 130 countries"). Statistics are not altogether reliable. Cf. WB 2008 Report, *supra* note 6, at 7 (citing 3,000 zones in 135 countries all over the world as of 2008).

²⁸⁶ See FOREIGN-TRADE ZONES MANUAL, *supra* note 284, at 23-24.

²⁸⁷ *Id.* at 71.

²⁸⁸ FOREIGN-TRADE ZONES BD., FREE TRADE ZONE FORMS 51 (2012), available at <http://ia.ita.doc.gov/ftzpage/history/forms.pdf> [hereinafter FREE TRADE ZONE FORMS].

²⁸⁹ See FOREIGN-TRADE ZONES MANUAL, *supra* note 284, at 60.

²⁹⁰ JOINT COMM. ON TAXATION, LISTING OF SELECTED INTERNATIONAL TAX CONVENTIONS AND OTHER AGREEMENTS (Dec. 31, 1991), available at <https://www.jct.gov/publications.html?func=startdown&id=3020>.

and later confirmed by the United States Foreign Investors Tax Act of 1966 and by the final draft of the Model Income Tax Convention.²⁹¹

E. Tax Treatment: Domestic Users and Foreign Exporters into USA FTZs Should Avoid “Permanent Establishments” and “Being Effectively Connected”²⁹²

Under the definition of a ‘permanent establishment’ in most of the existing income tax treaties, generally it is possible for an overseas exporter to have an agency in the host country which is not a ‘permanent establishment’ and, therefore, not taxable in that country.²⁹³ However, the agent must not habitually exercise general authority to negotiate or conclude contracts or have control over a stock of merchandise.²⁹⁴ This non-permanent establishment allows for display of merchandise for showroom purposes and enhances the use of a free trade zone without the threat of income taxation of the operation by the host government. However, caution must be followed to limit the agent’s activities, as indicated above.

The income tax conventions of the United States that enable foreign exporters to avoid double taxation by the U.S. and by their own country take precedence over the Foreign Investors Tax of 1966.²⁹⁵ However, the Internal Revenue Service could designate a showroom operation as being “effectively connected” with a trade or business that is a “permanent establishment” in the United States.²⁹⁶ In that case, it is possible for a foreign enterprise operating in the United States through an agent, office, or branch to be subject to United States taxation on certain income arising out of the display facilities.

Consequently, a domestic or foreign user of a United States foreign trade zone showroom must be careful to avoid the following three basic activities if the agent or office in the United States is not designated either as a “permanent establishment” or as “effectively connected with a permanent establishment”²⁹⁷:

- a) The agent with the United States must not be able to, or have authority to, negotiate or conclude a contract for the foreign company when calling on customers, and must be restricted from writing orders. However, the agent is allowed to take a pro forma listing of requested orders to the foreign company for approval and invoices which the agent sends to the customers.

²⁹¹ See generally RICHARD L. DOERNBERG, U.S. INCOME TAX TREATIES 320-321, 324 (1999); UNITED STATES MODEL INCOME TAX CONVENTION OF 1996 art. 14.

²⁹² This section of the paper relating to tax benefits was written with the assistance of Professor William Byrnes at Thomas Jefferson School of Law.

²⁹³ See KPMG, OECD - PROPOSED CHANGES TO THE DEFINITION OF “PERMANENT ESTABLISHMENT” IN OECD MODEL TAX CONVENTION (2012), available at <http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/transfer-pricing-oecd-definition-permanent-establishment.aspx>.

²⁹⁴ See Treas. Reg. § 509.101-2(1)(c) (1951).

²⁹⁵ David H. Brockway, Prepared Statement to the International Tax Counsel 11-13 (Apr. 29, 1980), available at <https://www.jct.gov/publications.html?func=startdown&id=4351>.

²⁹⁶ See UNCLEFED’S TAX BOARD, U.S. MODEL INCOME TAX CONVENTION ¶ 8 (1996), available at <http://unclefed.com/ForTaxProfs/Treaties/index.html>

²⁹⁷ JOHN F. AVERY JONES & DAVID A. WARD, AGENTS AS PERMANENT ESTABLISHMENTS UNDER THE OECD MODEL TAX CONVENTION 154, 155-156 (1993), available at http://www.unifr.ch/cdfpd/assets/files/publications/1993%20Agents_under_OECD.pdf.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

- b) The agent must not sell merchandise or fill orders from inventories owned by the foreign company and held in the United States. If selling merchandise or filling orders is done, the Internal Revenue Service will declare the office or showroom as a permanent establishment subject to the United States corporation tax.
- c) The agent or salesman in the United States must not arrange for advertising in or promote direct mail campaigns from the United States. This should be done by the parent company overseas, although the agent or salesman may recommend types of media to be used and may seek out the most rewarding methods of advertising for the foreign enterprise. All advertising contracts should be made directly from abroad with United States media. It is possible to prepare promotion pieces overseas, address envelopes there and hand carry or ship them in bulk to the agent for mailing in the United States in order to save on postage costs. This is a universally recognized system of distribution practiced by international publications and multinational companies.²⁹⁸

VIII. CUSTOMS-RELATED ISSUES FOR USERS OF FREE TRADE ZONES

In appraising the benefits of a free trade zone, a prospective user must fully appreciate that a zone is merely a parcel of real estate subject to whatever legal regulations normally apply to the site of its location. However, its key characteristic is that the area in which the real estate parcel is designated is considered to be outside Customs Territory. This limited extraterritorial status is the legal mechanism used for offering an exemption from the normal Customs-entry requirement of collecting duties on foreign goods immediately upon their arrival at a port of entry.

Unlike many countries of the world, the Congress of the United States passed the Foreign Trade Zones Act in 1934 to encourage operations in the United States that might otherwise have been carried out overseas for Customs reasons.²⁹⁹ The use of foreign trade zones in the United States is an outgrowth of Washington's purpose of imposing Customs duties to protect domestic industry rather than to raise revenues, as is the reason for Customs duties in most countries of the world.

Prospective users of free trade zones must remember that zones are used only for wholesale type transactions. Retail sales involving Customs exemptions are carried on at facilities known as duty-free shops which can be used by persons departing from a country. Retail duty-free shops operate under traditional Customs-bonded procedures. Free trade zone users should be familiar with another Customs procedure called "drawback." This permits the rebate of duties paid on components and materials used in export products.³⁰⁰ These rebates are requested by the user by means of a refund application upon the exportation of the end product only after specific control procedures are followed.

²⁹⁸ See generally *id.* at 159, 160.

²⁹⁹ See *Brief History of U.S. Foreign-Trade Zones Program*, FOREIGN-TRADE ZONE RES. CTR., <http://www.foreign-trade-zone.com/history.htm> (last visited Nov. 11, 2012) (discussing the purpose of, and amendments to, the U.S. Foreign Trade Zones Act) [hereinafter *A Brief History*].

³⁰⁰ MAMTA BHUSAN, CUSTOMS LAW – PROCEDURE 276, 296, 297 (2012), available at http://www.du.ac.in/fileadmin/DU/Academics/course_material/TM_21.pdf (for an overview of duty drawback).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Zone users also must be alerted to the rule that domestic goods entering a zone are considered exported products as soon as they enter a zone. These goods are classified as “zone restricted merchandise” and cannot be returned into Customs Territory.³⁰¹ However, this procedure benefits the zone user by accelerating excise tax and Customs duty rebates.

In contrast to the time of the Hanseatic League cities, which at the outset were free port cities with port areas available as zones for duty-free activities, today it is not unusual for foreign goods to arrive at seaports for rapid movement into inland port areas where free trade zones may be located. This is a natural growth of the increasing dependence upon air freight as more Customs entries are continually being made at inland ports. Such inland free trade zones as those in Little Rock, Kansas City, and Omaha in America are playing a vital part in the expansion of international trade in the mid-western United States.³⁰²

At the recommendation of the United States Treasury, Congress amended the Foreign Trade Zones Act in April, 1980 to exclude the cost of labor and other overhead expenses from Custom duties when goods are manufactured, processed, or assembled in a United States foreign trade zone.³⁰³ Products shipped from the zones into the United States Customs Territory are now assessed duties only on the value of their foreign parts and components. Prior to the 1980 amendment, duties on labor and other expenses incurred in a zone frequently made it prohibitive for companies to use a zone to manufacture because the duty levied on their additional charges made it impossible to compete with foreign-made goods. Because of these labor and other cost-savings adjustments, a number of zone tenants across the nation have undertaken a sizable expansion in operations, including Germany’s BMW at Mt. Olive (New Jersey Zone No. 44), Sweden’s Volvo (Portsmouth (Virginia) Zone No. 20), Japan’s Honda at Columbus (Cincinnati Zone No. 46B), Kawasaki in [Lincoln] ([Nebraska] Zone No. 59A), the French Le Saffae at Philadelphia Zone No. 35, and the United States Timex watch producer at Little Rock Zone No. 14.³⁰⁴

IX. AMENDMENTS PROPOSED BY U.S. FOREIGN TRADE ZONES BOARD TO FACILITATE INTERNATIONAL TRADE

On December 30, 2010, the Foreign Trade Zones Board

issued a proposed rule in the *Federal Register* to amend the substantive and procedural rules for the authorization of [FTZs] and the regulation of zone activity. These proposed changes would result in a major revision to the current regulations. . . . The revisions encompass changes related to manufacturing and value-added activities, as well as new rules designed to address compliance with the Foreign-Trade Zones Act’s (FTZ Act) re-

³⁰¹ R. Chris Wyatt, *Foreign-Trade Zone – Customs Treatment of Merchandise*, TAX AND FINANCING INCENTIVES: A TRIBAL PERSPECTIVE (1993), <http://greatspiritearth.com/wyatt2.html> (discussing zone restricted merchandise).

³⁰² See TIEFENBRUN, *supra* note 1, at 25, 87-91, 101-02, 107-09.

³⁰³ See *A Brief History*, *supra* note 299.

³⁰⁴ For more specific information about each of these zones in the United States, see TIEFENBRUN, *supra* note 1.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

quirement for a grantee to provide uniform treatment for the users of a zone.

[T]he proposed regulations would eliminate the general requirement for advance approval from the FTZ Board for most manufacturing (*i.e.*, substantial transformation) activity. As proposed, advanced approval for production activity would only be required for exports in certain rare circumstances (*e.g.* when an imported component in the manufacturing process is subject to antidumping or countervailing dut[ies]).³⁰⁵

The proposed changes “would significantly decrease the time a company must wait for approval.”³⁰⁶

The proposed provisions would also improve flexibility to accommodate changes in production at previously approved FTZ operations through retrospective notifications to the FTZ Board.

Two other . . . change[s] in the proposed regulations pertain to the statutory requirements that each zone be operated as a public utility and provide uniform treatment to all that apply to use the zone. . . . The proposed regulations would provide [better] guidance and would establish specific standards for compliance with [these] requirements.

[C]urrent regulations contain no provisions that address fines for violations of the FTZ Act or [the FTZ] Board’s regulations. The proposed regulations would implement the statutory authority to issue fines for violations of the FTZ Act or the Board’s regulations. . . . Each violation would be subject to a fine of not more than \$1,000[] each day in which a violation continues.³⁰⁷

Violations subject to such fines might be the

[f]ailure to obtain advance approval (or submit notification)...; [f]ailure to submit an annual report; or a conflict of interest in the agent’s performance of certain zone-related grantee functions that should not be undertaken by certain third parties. The proposed regulations contain a new provision allowing for the “prior disclosure” of violations of the FTZ Act or the FTZ Board’s regulations. Disclosure of a violation to the FTZ Board prior to its

³⁰⁵ DRINKERBIDDLE, FOREIGN-TRADE ZONE BOARD PROPOSES CHANGES TO FTZ REGULATIONS 1 (January 2011), <http://www.drinkerbiddle.com/resources/publications/2011/foreign-trade-zones-board-proposes-changes-to-ftz-regulations>.

³⁰⁶ *Id.* at 2.

³⁰⁷ *Id.* See also 15 C.F.R. §§ 400.42, 400.45, 400.62 (2012).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

discovery by the Board would generally result in the potential total fine for the violation . . . being reduced to \$1,000.³⁰⁸

Comments to the Board about these proposed new regulations were due on April 8, 2011.

Other comprehensive amendments have been proposed by the United States Foreign Trade Zones Board which would alter the U.S. Department of Commerce regulations³⁰⁹ covering a broad number of areas, including additional zones in ports of entry,³¹⁰ operations and physical requirements,³¹¹ applications for zone expansions, subzones, relocations and boundary modifications,³¹² and operations in zones subject to Customs supervision.³¹³ Another revision of the Foreign Trade Zones Board's regulations states that zones and subzones can be located only in or adjacent to ports of entry, with "adjacent" defined as being within 35 miles of the port. A Customs station is considered a port of entry if it is staffed by at least one full-time Customs officer. A more distant location may be considered "adjacent" if the subzone operator agrees to deliver the merchandise and its Customs documentation to the adjacent port designated by Customs for inspection before admission to and removal from the subzone. A bond is required by the Customs service to guarantee safe delivery and compliance with federal laws and regulations. An amendment to the Foreign Trade Statistics Regulations by the Bureau of Census³¹⁴ changed the statistical information required as a result of the revised system of handling United States Foreign Trade Zones admissions and exportations.³¹⁵

Meanwhile, a number of United States Congressmen have become critical of United States Foreign Trade Zones, claiming that the economic impact of the zones is detrimental to the American economy as a whole. In April 1990, several Representatives introduced and passed the Foreign Trade Zones Improvements Act which would, among other things, abolish a public interest criteria for the approval of new zones based on the local economic and employment impact of a proposed zone.³¹⁶ Sponsors insist that the approval procedure must consider the country as a whole, rather than a single community.

Realizing some of the drawbacks of the outdated U.S. Foreign Trade Zone Act of 1934,³¹⁷ in late 1990 the United States Foreign Trade Zones Board proposed amending certain sections of the January 26, 1990 proposed rule by adding new provisions, including a new section for the collection of user fees to cover the costs of processing zone applications. The proposed ruling also included the elimination of subzone locational restrictions with respect to geographic distances from ports of entry. A new paragraph was added to the proposed ruling extending coverage of applications to formal requests for revisions to grants of authority. Time schedules, based on the time allocated to various stages of the application process, were revised in order to expedite decisions of the Board. It was also proposed that

³⁰⁸ DRINKERBIDDLE, *supra* note 305, at 3. *See also* 15 C.F.R. § 400.63 (2012).

³⁰⁹ *See* 15 C.F.R. § 400 (2012).

³¹⁰ *See id.* at § 400.302.

³¹¹ *See id.* at § 400.401.

³¹² *See id.* at § 400.605.

³¹³ *See id.* at § 400.800.

³¹⁴ *See* 15 C.F.R. § 30.1.

³¹⁵ *Id.*

³¹⁶ *See* Rep. Donald J. Pease, *Foreign Trade Zones Improvement Act*, Rep. Pease, Donald J., 101st Congress, H.R.4392 (Mar. 27, 1990).

³¹⁷ *See* 15 C.F.R. § 400.29 (2012).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

the threshold provisions be revised to clarify the conditions concerning policy considerations. Instructions on requests from interested parties for hearings also were added. On November 7, 1991, new or revised regulations that address a number of the criticisms leveled at zone approval procedures and operations were implemented. Essentially, the revisions codify existing practices for establishing general purpose zones, but major changes have been made with respect to the authorization of manufacturing and processing activities within zones and subzones. The basic test for establishing zones was unchanged, and the current practice of requiring subzone applicants to provide evidence of "significant public benefit" has been codified. When appropriate, subzone authorizations will be subject to restrictions that limit zone benefits to export shipments and duty deferral.

A new provision specifies the factors to be considered when the U.S. Foreign Trade Zones Board reviews prospective or ongoing manufacturing authority. The first step considers policy issues and, if there are compelling reasons for a negative decision, the decision may be made without consideration of the net economic effect. With respect to zone or subzone applications, procedures have been simplified by reducing the number of required exhibits from thirteen to five, and those relating to economic justification are now more detailed than before.³¹⁸

In addition, a target date has been established for deciding on applications. General purpose zones are to be decided within ten months, with one year allowed for manufacturing subzones. For the first time, zone applicants will be charged a fee, which may be as high as \$6,500. The range of possible locations for general purpose zones has been broadened by extending the distance a zone can be from the outer limits of ports of entry to 60 miles from the present 35 miles. Finally, a new rule subjects items transformed in zones to antidumping and countervailing duties based on their condition when they enter the zones. Previously, the determination was made on a case-by-case basis.

A number of zones are turning to computers to automate the mounds of paperwork involved in record keeping. However, because United States Customs does not have a model for computerization of zone information, the National Association of Foreign Trade Zones is advising a go-slow approach to automation for fear that zones will set up systems that are not consistent with national standards once they are adopted. The Association also is urging Customs to move forward with standardization for electronic documents.

Not only is the National Association of Foreign Trade Zones focusing on helping zones become more automated, but it is also devoting considerable effort to educate the business community about how zones operate, what they do, and what are their benefits.³¹⁹ The Association is working with Customs to identify new people who will work with the Association in the future to make sure that Customs officials understand the problems and issues that operators face. Several training programs have been held at the Federal Law Enforcement Training Center of Atlanta, Georgia. Here entire Customs training modules are presented so that operators may understand what the Association is doing to teach the Customs staff about the daily operation of zones.

³¹⁸ See generally *id.* at § 400.600. See also 15 C.F.R. § 400.28 for a discussion of the "lapse provision" whereby zones approved prior to November 8, 1991 and not activated by November 8, 1996 lose their zones status, and their grant is considered void.

³¹⁹ *Mission and Goals*, NAT'L ASS'N OF FOREIGN-TRADE ZONES, <http://www.naftz.org/about-us/mission-and-goals/> (last visited Dec. 13, 2012).

X. ENTERPRISE ZONES

A. Enterprise Zones, Empowerment Zones, and Their Public Service to the U.S. Economy

One of Washington's programs to restore economic health to the battered and depressed urban areas in New York, the Watts section of Los Angeles, and certain other districts such as Chicago, Detroit, and Seattle, is the establishment of the Enterprise Zone.

As one of the original promoters of enterprise zones in the United States, the former Secretary of Housing and Urban Development, Jack Kemp, is well aware of the controversial status of enterprise zone operations in America. For instance, in Miami, the Beacon County Council claims that in a period of two years, 21 companies were established or expanded in the Dade County Miami Enterprise Zone. The Council says that those companies created 1,628 jobs and generated \$30 million in investment. On the other hand, some researchers have found that many zones have had only modest success and that it is unclear if job growth and investment are a result of the zones.³²⁰ Moreover, companies frequently take advantage of incentives by laying off workers in one part of the county and hiring new ones in the zone. Generally, enterprise zone studies indicate that businesses relocate into enterprise zones to be near their source of raw materials and markets.

Under the Omnibus Budget Reconciliation Act of 1993,³²¹ "empowerment zones" may be created in nine communities, and "enterprise zones" may be established in 95 communities designated by the government. Companies operating in these zones are granted a 20% credit against federal taxes for all qualifying employees for the first \$15,000 of qualified wages paid. The maximum credit for each qualified employee allowed is \$3,000. In addition, 25% of the employer's alternative minimum tax may be offset by the credit. In the case of enterprise zones, depreciable property expense allowed also is increased from the normal \$17,500 to \$20,000 or the lesser of the cost of "qualified zone property" placed in service during the taxable year.

New Jersey has thirty-two urban enterprise zones, which have been highly successful for job creation and business investment.³²² New York's successful program has certified 540 businesses for zone participation, with 120 of those from out of state.

B. Enterprise Zones in the World and Their Economic Benefits

The Enterprise Zone technique initiated by the United Kingdom has been quite successful in 27 locations and includes economically depressed areas. In April 1989, Britain approved its 27th and last Enterprise Zone, this one on 150 acres covering several sites in Sunderland, northeast England. Part of the zone is near the Nissan car factory at Washington and the auto manufacturer is expected to use the zone. The Tyne and Wear Development Corpora-

³²⁰ Steven Greenhouse, *New Support but Few Gains For Urban Enterprise Zones*, NY TIMES (May 25, 1992), available at <http://www.nytimes.com/1992/05/25/business/new-support-but-few-gains-for-urban-enterprise-zones.html?pagewanted=all&src=pm>.

³²¹ See Omnibus Budget Reconciliation Act of 1993, H.R. 2264, 103rd Cong. §1391(b) (1993-1994).

³²² See *Urban Enterprise Zone Program*, STATE OF N.J. DEP'T OF CMTY. AFFAIRS, <http://www.state.nj.us/dca/affiliates/uez/index.shtml> (last visited Dec. 13, 2012).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

tion's riverside land is also part of the zone. The success of the British Enterprise Zone system prompted the United Kingdom Treasury and Trade Departments to consider implementation of a network of freeports to simplify Customs procedures and attract a greater share of international trade. Following the success of the Enterprise Zones and the creation of the first free port on the British Isle of Man, the British Government established six free ports within the United Kingdom. In February 1984, the British Government chose the six sites as the nation's first experimental "freeports." These are Southampton, Liverpool, Cardiff, Birmingham, Prestwick, and Belfast. The last three are situated at the respective airports.

The Southampton Freeport is managed by a consortium headed by the Associated British Ports. Liverpool operates as a free port in an area encompassing the Alexandra, Hornby and Gladstone, and Royal Seaforth docks. It is being run by the Mersey Docks and Harbour Company. The Cardiff Freeport, also managed by Associated British Ports, has set aside 45,000 square meters of covered storage space and 21 acres of open land. The zone in Belfast, Northern Ireland is at the Belfast International Airport. It occupies 25,000 square feet initially, and available space will be increased to 125,000 square feet over a three-year period. The undertaking at Liverpool covers a 650-acre facility. The freeports are being established for a five-year trial period to test their ability to attract new industry and provide new employment opportunities. The United Kingdom freeport zones must follow the rules established by the European Union under the Free Zone Regulations effective as of August 6, 1984, which were approved by the Commissioners of Customs and Excise of the EU. Consisting of Parts I to IX, the regulations cover the basic free trade zone concept of Customs-duty exemptions but are more specific on chargeable duties when goods are removed from a zone for home use or remain in a free zone after being entered for home use or free circulation. Part IX on the value-added tax regulation includes instructions and rules on tax charges on removal from free zones of manufactured goods and relief from import tax following supply to non-registered persons.

Already concerned about the impact of the European Union, many United States exporters are fearful that the creation of the large 27-nation (soon to be 28-nation) European free trade zone will mean stiffer competition for American products. Before the establishment of the European Union, the EEC and the European Free Trade Association (EFTA), then composed of Norway, Sweden, Finland, Switzerland, Austria and Iceland, planned to set up a European Economic Space or European Economic Area.³²³ The two European blocs hoped to permit the free exchange of goods, services, labor, and capital between the EU and EFTA. American products most likely to be affected adversely by the European trade union are paper, semiconductors, and telecommunications equipment. These plans changed when the EEC became the EU and expanded to 27 nations, including Sweden, Finland, Austria, and former Eastern European nations once under Soviet control.

Eastern Europe has more than two dozen active free trade zones in Romania, Bulgaria and Poland, while many parts of the former Soviet Union have been contemplating setting up free economic zones.³²⁴ After the establishment of the Free Economic Zone legislation in 1995, Lithuania set up free trade zones in Šiauliai, Klaipėda, and Kaunas. Hungary, too,

³²³ Robert Hosking, *A Brief Guide to the European Economic Space*, SPECTREZINE, <http://www.spectrezine.org/europe/hosking2.htm> (last visited Dec. 13, 2012).

³²⁴ See generally The Chinese University of Hong Kong, *Regional Trading Agreements*, INT'L ECON. (2000), <http://intl.econ.cuhk.edu.hk/rt/index.php?did=25>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

adopted a special economic zone law, allowing export processing zones.³²⁵ Likely Russian zone sites in addition to the operational zone at Nakhodka in the Far East are Vyborg near St. Petersburg, the Kuzbass coal fields, the Port of Ilychevsk near Odessa on the Black Sea, the Kola Peninsula near the Arctic Port of Murmansk, the Saimas Canal near Finland, and Novgorod. Also under consideration as free trade zones are Vostochny on the Sea of Japan, Korsakov on the southern tip of the Sakhalin Island near Japan, and Petropavlovsk Kamchatsky on the Kamchatka peninsula in the northern Pacific along the Bering Sea. Legislation includes special provisions for foreign investors with respect to capital contributions, currency exchange, reduced taxation, Customs-free duties, 100% foreign equity, and arbitration.

In addition to duty-free exports and imports, the zones provide a reduction in Customs duties and lease-payment discounts. For non-State supplied materials, foreign and domestic enterprises are able to set prices. Each zone has a bank that sells currency at official exchange rates, but there is also optional selling of foreign currency at market rates. Regulations simplify the arrival of foreign citizens working in the zones. So far, dozens of requests for free economic zones have been submitted, and ten areas have been designated for zone operations at the outset. The first concrete step was taken in mid-1990, when the Parliament of the Russian Republic, the former Soviet Union's largest, declared Vyborg one of a half-dozen joint-enterprise zones. Located on the Gulf of Finland in northern Russia, Vyborg is a half-day's drive from Helsinki and the offices of numerous multinational companies. The original zone called for a five-year transition period during which Western investors would be required to participate in joint ventures with local partners. Tax incentives include a three-year tax holiday on profits, after which the levy would be 10%. Under Russian law, foreign joint ventures are taxed at 30% with revisions in the law increasing the rate to 60%. These revisions were subsequently revoked. An independent Vyborg bank also is envisioned, which would exchange dollars at rates more attractive than those offered by the Russian Central Bank. The lack of free ruble convertibility and repatriation of profits remain formidable obstacles for Western investors,³²⁶ but some see the opportunity to get in at the beginning as a distinct attraction.

As part of a United Nations Development Program project to develop industry along the Tumen River in North Korea, free ports also are being created in Najin and Sonbong, with tax-free industrial zones in the latter two cities.³²⁷ A three-year tax holiday and reduced tax rates thereafter will be offered to joint ventures of foreign and North Korean concerns.

No matter what descriptive terminology is used, i.e., export processing zone, industrial free zone, freeport, or, simply warehousing zone, the facilities of Customs deferrals and exemptions are alike. The zone user makes the choice of paying duties either on the foreign goods and materials or on the finished products. In some jurisdictions outside the United States, income tax-exempt benefits and other tax concessions other than Customs tax exemptions are also extended to qualifying zone users.

³²⁵ See generally *Special Economic Zones*, INVEST LITH., <http://www.investlithuania.com/en/doing-business/investment/special-economic-zones> (last visited Dec. 13, 2012); *Free Trade Zones/Warehouses*, KISH TRADE PROMOTION CTR., http://www.kishtpc.com/Free-En/free_hungary.htm (last visited Dec. 13, 2012).

³²⁶ Susan W. Tiefenbrun, *Joint Ventures in the USSR, Eastern Europe, and the People's Republic of China as of December 1989*, 21 N.Y.U.J. INT'L L. & POL. 667, 672 (1988-1989).

³²⁷ See generally Bell, *supra* note 252.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

XI. APPLICATION OF NATIONAL LAWS TO FREE TRADE ZONES

Some non-Customs-related national and local laws do apply to free trade zone facilities. In the United States, federal income taxes apply to most foreign trade zones located in the U.S. In some developing countries, the tax concessions offered by the government to domestic or foreign investors apply. However, free trade zones are subject to Customs in some form or another in order to protect the integrity of the Customs systems. At present the Customs Service in the United States raises funds annually through user fees on imported goods and on persons and carriers entering the country. Since a United States foreign trade zone is a neutral territory, the exclusion of this levy on zone users would be a considerable stimulant to operations of export processing in zones. To facilitate operations of the United States foreign trade zones and to provide a more efficient interchange of information, practically all of the zones are members of the National Association of Foreign Trade Zones, which periodically meets in various regions of the United States. The Association has established a full-time Washington, D.C. office that works on solutions for export-import problems with the U.S. Census Bureau, the U.S. Customs and Border Protection, and the Foreign Trade Zones Board. A manual on zone Customs procedures is one of its projects.

XII. TAX BENEFITS OF FOREIGN TRADE ZONES IN THE U.S.³²⁸

Income on profits in the United States Foreign Trade Zones is not exempt from federal income, capital dividend, royalty, interest, and other passive income taxes. Some of the individual states do exempt businesses operating in the zones from property taxes.³²⁹ This would be in addition to the exemption from Customs and excise taxes.

A. Corporation Income Tax and Payment

For the tax year beginning on January 1, 1993,³³⁰ the corporate income tax rates are 15% for the first \$50,000 of income, 25% of the amount over \$50,000 up to and including \$75,000, 34% of the amount over \$75,000 and up to and including \$100,000, 39% of the amount over \$100,000 up to and including \$335,000, reverting to 34% of the amount over \$335,000 up to and including \$10,000,000, then 35% of the amount up to and including \$15,000,000. For amounts over \$15,000,000, 38% applies up to and including \$18,333,333, after which a rate of 35% applies to the remainder of the income.

All corporations must pay an estimated tax in four periodic installments on the fifteenth day of the fourth, sixth, ninth, and twelfth months, based either upon a calendar or fiscal year.³³¹ Generally corporations must pay at each installment at least 25% of the lesser of the estimated tax liability of the current year, or the actual positive tax liability of the previous

³²⁸ This section on Tax Benefits was written by Associate Dean William H. Byrnes and Prof. Hannah Bible, Walter H. & Dorothy B. Diamond International Tax & Financial Services Graduate Program, Thomas Jefferson School of Law.

³²⁹ See discussion *infra* Part XIV - Special Inducements.

³³⁰ See I.R.C. § 11(b) (2012). These corporate tax rates apply today as confirmed on March 18, 2011.

³³¹ See I.R.C. § 6655(c), (i).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

year.³³² However, large corporations, defined as having a taxable income exceeding \$1,000,000 in any of the previous three tax years, must for the final three -installments of the year base their payments on the current year's estimate.³³³

B. Corporation Alternative Minimum Tax

In general, a corporation is subject to an alternative minimum calculation of its tax base known as the alternative minimum tax ("AMT") regime. The AMT regime requires a second upward adjusted calculation of the corporation's taxable income by denying certain deductions and credits. Thus, a corporation may incur an AMT liability wherein under the normal corporate tax regime, it may have none. Tax liability paid pursuant to the AMT calculation is potentially a pre-payment of tax in that such payments may be recaptured when the corporation's regular tax payments exceed the AMT liability.

Pursuant to the alternative minimum tax regime for corporations that are not deemed to be small corporations, for each taxable year corporations must pay a minimum 20% tax liability upon their alternative minimum taxable income exceeding an exemption amount.³³⁴ Small companies are defined as earning less than \$5,000,000 gross receipts on average over the first three years of establishment, increasing to \$7,500,000 on average thereafter.³³⁵ The AMT exemption amount begins at \$40,000 but is subject to a progressive phase-out based upon the AMT liability.³³⁶ However, AMT may be reduced by foreign tax credits allowed by this regime.³³⁷ The AMT rate for an individual taxpayer is 26% of the excess, above an exemption amount based upon filing status, up to and including \$175,000, increasing to 28% of the amount above \$175,000.³³⁸

For the purposes of the adjusted calculation of the AMT, whether depreciation is allowed at the level of that under the normal corporation tax regime depends first upon what cost recovery system is being employed for the asset which in itself is determined based upon the year the asset enters into service: after 1986, the Modified Accelerated Cost Recovery System (MACRS), from 1986 until and including 1981 the Accelerated Cost Recovery System (ACRS), and before 1981 the pre-ACRS.³³⁹ For MACRS, the AMT adjustment calculation further depends upon whether the property employed after 1986 through 1998, or from 1999. Upon determining the date of deployment, the MACRS adjustment next depends upon the classification of the property as tangible or intangible, and whether the property is real or personal.³⁴⁰ For the AMT adjustment, tangible property deployed from 1999 shall use the 150% declining balance method; however, changing to the straight line method for the first

³³² See I.R.C. § 6655(d)(1).

³³³ See I.R.C. § 6655(d)(2), (g)(2)(A).

³³⁴ See I.R.C. § 55(b)(1)(B).

³³⁵ See I.R.C. § 55(e).

³³⁶ See I.R.C. § 55(d)(2)-(3).

³³⁷ See I.R.C. § 55(b)(1)(B)(ii).

³³⁸ See I.R.C. § 55(b)(1)(A)(i), (d)(1).

³³⁹ See generally I.R.C. § 56(a)(1).

³⁴⁰ See *id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

year by which it will yield a higher allowance.³⁴¹ However, the AMT regime generally employs the straight line method with real property.³⁴²

Generally, property acquired over \$1,000,000 after January 1, 1993 (option permitted for property acquired after July 1, 1991) is granted a 15-year amortization of most intangible assets purchased.³⁴³

C. Capital Gains

Short-term gains for individuals and corporations, as well as long-term gains for corporations, are subject to normal income tax rates. For long-term gains on which the asset is held at least 12 months, most individuals will incur a 15% rate for the years 2008–10, and 20% in the year 2011. However, in 2008–2010 low-income earners who pay the 15% or less ordinary tax are subject to a zero tax rate for long-term capital gains, increasing to 10% in 2011. Capital losses may be used to offset capital gains to determine the net capital gain (or loss).

D. FOREX (foreign exchange)

Revised FASB Statement No. 52 of 1982 permits companies to report their foreign exchange gains and losses by placing them directly in stockholders' equity on the balance sheet, and the adjustments do not have to be reflected in the companies' earnings.

E. Branch Profit Tax for Foreign Corporations

The 1986 Tax Reform Act imposes a branch level tax of 30% on profits realized by a United States branch of a foreign corporation to the extent that the profits are not reinvested in additional United States branch property, or remitted to the foreign corporations head office.³⁴⁴ A 30% tax also is levied on interest payments by the foreign corporation to foreign creditors up to the extent that the loan and interest expense is connected to the branch's operation in the United States.³⁴⁵

F. Payment to Non-residents

Dividends, interest, and royalties remittances to a non-resident are generally subject to a 30% withholding tax, unless the United States has an Income Tax Convention avoiding double taxation with the country in which the recipient of the remittance is a resident.³⁴⁶ In these cases, the rates may be reduced to 15% or 5% or exempt entirely from withholding.

³⁴¹ See I.R.C. § 56(a)(1)(A)(ii)(I)-(II).

³⁴² See I.R.C. § 56(a)(1)(A)(ii)(II). See also I.R.C. § 1250(c).

³⁴³ See I.R.C. § 197(a).

³⁴⁴ See I.R.C. § 884.

³⁴⁵ See I.R.C. § 884(f).

³⁴⁶ See I.R.C. § 871(a).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Additionally, interest that is paid by most banks and payments qualifying as portfolio interest may be exempt from tax.³⁴⁷

G. State Level Tax

State taxes ranging from 0% to 12% also may be levied on the taxable income, which generally does not differ materially from federal taxable income. Some states also have a franchise tax, in lieu of the income tax. Property taxes, including real estate taxes, usually are imposed by the local governments. Sale taxes, payable at the retail level, are levied at rates varying from 0% to 8.25%.

H. State Level Tax Base

Under a U.S. Supreme Court decision of *Container Corporation of America* (1983),³⁴⁸ reinforced by *Barclays Bank* (1994),³⁴⁹ states may include the worldwide income in computing state income tax liability. Both decisions permit a state to tax a multinational corporation under a formula that allocates a portion of the corporation's total income to a particular state. The 1983 U.S. Supreme Court decision evolved from the case of *Container Corporation of America* (CCA), a subsidiary of the Mobil Oil Corporation, which is incorporated in Delaware and has its corporate headquarters in Illinois, with 20 foreign subsidiaries. CCA had excluded the subsidiary earnings from the California Franchise Tax for a three-year period, but its tax liability was recalculated by the state's franchise tax board on a worldwide basis of earnings, suing for a refund. The Supreme Court indicated that the Constitution permits a state to treat the domestic and overseas operations of a multinational corporation as a "unitary" business and apply its ordinary tax formula to the corporation's worldwide earnings regardless of their geographic source.

California pioneered the "unitary" method in the 1930s but in 1986 adopted a water's edge alternative method that gives multinational corporations an acceptable option on taxing their worldwide profits. Presently, only a few states use the water's edge method, but over 20 states retain a similar law of taxing part or all of a multinational corporation's worldwide earnings using the "unitary" method. Other states adopt the traditional "arm's length" tax method under which the earnings of a domestic company's foreign subsidiaries are excluded from the company's state tax base. Sixteen states, addressing intercompany payments require taxpayers to add back certain income and expenses paid to related parties.

The following tax rates apply to individuals based on filing status³⁵⁰:

- (1) Single filing status
 - 10% on income between \$0–\$8,925
 - 15% on income between \$8,925–\$36,250
 - 25% on income between \$36,250–\$87,850
 - 28% on income between \$87,850–\$ 183,250
 - 33% on income between \$183,250–\$3398,350

³⁴⁷ See I.R.C. § 871(h).

³⁴⁸ *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

³⁴⁹ *Barclays Bank PLC v. Franchise Tax. Bd. of California*, 512 U.S. 298 (1994).

³⁵⁰ Numbers updated to reflect 2013 tax rates.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

- 35% on income between \$398,350-\$400,000
- 39.6% on income above \$400,000+
- (2) Married filing jointly
 - 10% on income between \$0-\$17,850
 - 15% on income between \$17,850-\$72,500
 - 25% on income between \$72,500-\$146,400
 - 28% on income between \$146,400-\$223,050
 - 33% on income between \$223,050-\$398,350
 - 35% on income between \$398,350-\$450,00
 - 39.6% on income above \$450,000+
- (3) Married filing separately filing status
 - 10% on income between \$0-\$8,925
 - 15% on income between \$8,925-\$36,250
 - 25% on income between \$36,250-\$73,200
 - 28% on income between \$73,200-\$111,525
 - 33% on income between \$111,525-\$195,175
 - 35% on income between \$195,175-\$225,000
 - 39.6% on income above \$225,000+
- (4) Head of household filing status
 - 10% on income between \$0-\$12,750
 - 15% on income between \$12,750-\$48,600
 - 25% on income between \$48,600-\$125,450
 - 28% on income between \$125,450-\$203,150
 - 33% on income between \$203,150-\$398,350
 - 35% on income between \$398,350-\$425,000
 - 39.6% on income above \$425,000+

I. Social Security Taxes

Under the Federal Insurance Contributions Act (FICA), employees pay 7.65% social security taxes. FICA consists of a Social Security tax and Medicare tax. Every employer must withhold 6.2% from the employee's wages paid up to \$113,700 for the Social Security tax, and 1.45% on all earnings for the Medicare tax.³⁵¹ Self-employed individuals pay 12.4% on earnings up to \$113,700 for the Social Security tax and 2.9% on all earnings for the Medicare tax.³⁵² However, to the extent an agreement exists with a foreign country, income may be exempt from such taxes.³⁵³ Aliens living abroad are subject to a 15% withholding tax on United States Social Security payments.

Aliens classified as United States residents for income tax purposes are subject to Social Security taxes if they work abroad for a United States employer. Non-resident aliens also are subject to Social Security taxes on all income received. The Federal Unemployment Tax Act requires employers to pay an unemployment insurance levy of 6.2% based on the first \$7,000 of wages paid during the calendar year, if these wages were earned from January

³⁵¹ See I.R.C. § 3111(a)-(b).

³⁵² See I.R.C. § 1401(a)-(b).

³⁵³ See I.R.C. § 1401(c). See also I.R.C. § 3111(c).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

1, 1988 to June 30, 2011.³⁵⁴ For the remainder of 2011 and thereafter, the rate drops to 6%. Since employers can receive a maximum 5.4% credit for state unemployment taxes paid, the net payable is 0.8% of \$56 per employee.³⁵⁵ Earned income is defined as “personal service income” and includes wages, salaries, professional fees, and -compensation for personal services, including royalty payments to authors and inventors, and pension and annuity income.

J. Income as to U.S. Non-residents

Non-resident alien individuals who do not have income effectively connected with the conduct or trade or business within the United States generally are subject to a 30% withholding tax on wages and salaries, investment, and other fixed or determinable annual or periodical income from sources within the United States. If the income is “effectively connected” with the conduct of a trade or business within the United States, the aforementioned normal individual tax rates apply. The 30% withholding does not apply to portfolio interest paid to non-resident aliens and foreign corporations by United States borrowers. Portfolio interest is defined as interest paid on obligations that are not in registered form (bearer debt) and paid outside the United States, and interest on registered obligations when a statement is filed indicating that the owner is not a United States person. Bearer debt will not escape the 30% withholding if the foreign payee has a 10% or more ownership interest in the United States payor. Even if the interest otherwise qualifies for the exemption, it is subject to withholding if the exchange of information between the United States and the foreign country is inadequate to protect tax evasion by the United States persons.

United States corporations (with foreign shareholders that do not file a report with the Internal Revenue Service declaring they are not United States real property holding companies) (*i.e.* less than 50% of assets are in United States real property for the prior four years) are deemed to be United States real property holding companies and subject to normal taxation on gains from the sale of stock.³⁵⁶ Purchasers of United States real property interests from foreign persons generally must withhold 10% of the gross amount paid for the property, as the foreign sellers are subject to a 10% tax on the sale of such interests.

United States corporations when doing business in United States territories and other possessions may be considered foreign resident corporations. For example, Foreign Trade Zone No. 7 falls under the Puerto Rican Income Tax Code. Under the Puerto Rican Income Tax Code, domestic and foreign corporations are subject to the normal income tax of 20% of net income. In addition, there is a 5% surtax on surtax net income up to \$75,000, graduating to a 19% on surtax net income over \$275,000. Surtax net income is equal to normal tax income less a \$25,000 exemption plus 5% over \$500,000. Only one \$25,000 surtax exemption for any group of corporations under common control is allowed. This surtax may be divided equally among the members of the partnerships or corporations or prorated among them. For the taxable years 2009–2011, the maximum effective tax rate is 40.95%. Net operating losses may be carried forward for seven years but may not be carried back.

Dividends paid to Puerto Rican domestic corporations are taxed at 10%. Interest, loans, and royalties paid to non-resident corporations are subject to 29% tax for non-U.S. na-

³⁵⁴ See I.R.C. § 3301.

³⁵⁵ See I.R.C. § 3302(b).

³⁵⁶ See I.R.C. § 1445(b).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

nationals and 20% tax for U.S. nationals. Distributions representing dividends and partnerships profits not engaged in business in Puerto Rico are subject to 10% withholding tax.

All corporations and partnerships engaged in trade or business in Puerto Rico qualify to receive a deduction for dividends received, limited to 85% of the recipient's income, from corporations organized under the laws of Puerto Rico or on profits of partnerships organized in Puerto Rico, respectively. Dividends paid by a corporation or partnership which is exempt from taxation under the Industrial Incentive Act are exempt from taxation if paid to a foreign corporation not subject to taxation in any jurisdiction other than Puerto Rico or the United States.

Individuals are subject to a progressive tax on net taxable income graduating to a rate of 33%. An additional surtax is imposed on individuals whose gross income exceeds \$100,000 (\$150,000 for married filing jointly). Individuals whose normal tax does not exceed a minimum tax are subject to an alternative minimum tax of 10% of adjusted gross income ("AGI") between \$75,000 and \$125,000, 15% between AGI of \$125,000 and \$175,00, and 20% of AGI over \$175,000.

In reference to the Virgin Islands, under the 1986 Exempt Company Legislation, a company qualifying as an exempt company is exempt from all United States Virgin Islands income gross receipts and withholding taxes and from license requirements under a 20-year contract guaranteeing the tax exempt status after the company is organized. To qualify, an exempt company must have less than 10% of the total voting power of the stock or the total value of the stock must be owned directly or indirectly by one or more of United States or United States Virgin Islands persons.

XIII. U.S. GOVERNMENT GUARANTEES TO USERS OF FOREIGN TRADE ZONES

Under the United States Foreign Trade Zones Act, as amended, the United States guarantees that there will be no Customs or excise taxes in the foreign trade zones.³⁵⁷ The Government guarantees free convertibility of currency and does not restrict transfers of capital and profits. Export credit guarantees are available from the Export-Import Bank of Washington, and export credits insurance guarantees may be granted by the Foreign Credit Insurance Association in amounts up to 95% of political risk and 90% of commercial risk covered.

XIV. SPECIAL INDUCEMENTS OFFERED BY FTZS

A. Federal Incentives

(1) The Modified Accelerated Cost Recovery System (MACRS) was introduced when the Tax Reform Act of 1986 revised the Accelerated Cost Recovery System (ACRS), eliminating some of the benefits previously allowed.³⁵⁸ For instance, the rules effective in certain cases for property costs committed after March 1, 1986, are designed to match class lives more evenly with the economic or useful lives of assets. However, deductions still are

³⁵⁷ 19 U.S.C. § 81a-81u.

³⁵⁸ See The General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99TH Congress, 99-514, Joint Committee on Taxation, (1986), available at <http://www.jct.gov/jcs-10-87.pdf>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

accelerated more propitiously for most businesses than before the 1981 regulations. The 1986 Tax Reform Act guidelines are based on the pre-1981 Asset Depreciation Range (ADR) system. Assets are assigned to one of the six classes of depreciable personal property or to one of two classes of real property. Costs in the three, five, seven- and ten-year classes are the double declining balance depreciation method for recovery. Cars and trucks are in the five-year class and most equipment is in the seven- and ten-year class. If the costs of assets are in the 15–20-year classes, then the recovery costs use the 150% declining balance method. The straight line method is used for all real estate. Residential realty is in the 27.5-year class. Non-residential real property is in the 31.5-year class if placed in service after 1986 and on or before May 12, 1993.

(2) Under the 1986 Tax Reform Act system, approximate recovery percentages for three-year property are 33% in the first year, 45% in the second, and 15% in the third and 7% in the fourth year. Based on a 4% inflation rate and a 4% real rate of return, the approximate cost recovery for autos is 96%, for computers, mining equipment and grain 98%, for railcars and pipelines 87%, for electric generators and telephone distribution 76%.

(3) Some passenger automobiles placed in service in 2008 and 2009 were eligible for a 50% additional first-year depreciation deduction. The total depreciation deduction that may be taken for passenger automobiles eligible for the 50% deduction and placed in service in 2008 and 2009 is \$10,960 for the first year, and for passenger automobiles not eligible for the 50% deduction it is \$2,960. In 2010, no 50% depreciation is available; hence this year the maximum depreciation in the first year of service is \$3,160. In each case, the depreciation deduction in later years is \$4,800 for the second year (2010: \$5,100), \$2,850 for the third year (2010: \$3,050), and \$1,775 for each succeeding year (2010: \$1,875).

(4) In addition to the depreciation deductions, some depreciable equipment purchased during the year may be expensed up to \$250,000 (for 2007 to 2010 tax years). The deduction is phased out when qualifying property exceeding \$800,000 is purchased during the year. Property eligible for the expense election includes only tangible depreciable property (property that would have been eligible for the now eliminated investment tax credit if it were available) acquired for use in the active conduct of a trade or business. The expense amount may not exceed the taxable income left after subtracting the amount that is expensed in the year of purchase for the purchase price of the equipment.

(5) There is a 20% credit for certified rehabilitation of certified historic structures and a 10% credit for other eligible buildings. For buildings, other certified historic structures must have been placed in service before 1936. To qualify, a 50% external-wall retention test must be met or alternatively 75% of the external wall must be retained within either the external or internal walls.

(6) Research and experimental expenditures may be either capitalized or deducted immediately. If current expenses treatment is elected, all qualifying expenses must be deducted in the year the expenses are incurred for the year of election and all future years, unless the taxpayer secures IRS approval to capitalize the expenses. Qualifying expenditures generally include most research and development costs incidental to the development or improvement of a product.

(7) Grants and other financial assistance are available from the Small Business Administration, Rural Electrician Administration, Federal Land Bank, and certain government agencies.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

(8) The Individual Retirement Age (IRA) contribution rules allow an employee or self-employed person a tax-free deduction of up to \$5,000 a year (\$6,000 for individuals aged 50 or over) for the year 2010 and for future years the amount will be annexed to inflation. The deductions are phased out when income is between \$105,000 and \$120,000 when single and between \$167,000 and \$177,000 for married couples filing joint returns. Tax exemptions are allowed until the IRA investment earnings are withdrawn. Generally, a 10% excise tax is levied on excessive distributions on all qualified retirement plans.³⁵⁹

(9) Special credits ranging from 10% to 30% are available for energy properties put into service in the year of purchase. Certain advanced qualifying energy projects may be granted up to 30% credit for the cost of project.

(10) Loan guarantees are available for domestic and foreign-owned farmers under the Farmers Home Administration for commercial and industrial projects that increase employment in rural areas.

(11) The 1986 Virgin Islands Exempt Company legislation permits a company qualifying as an exempt company to be exempt from all United States Virgin Islands income gross receipts and withholding taxes and from license requirements under the 20-year contract guaranteeing tax exempt status after the company is organized.³⁶⁰

B. Foreign Service Corporation

The Deficit Reduction Act of 1984 replaced the Domestic International Sales Corporation (DISC) legislation in the 1971 and 1982 laws with new Sections 921 through 927 of the Internal Revenue Code allowing for the establishing of Foreign Sales Corporations (FSCs) and exclusions of income taxes on the deferral income of a DISC whose taxable year began before January 1, 1985, and closed on December 1, 1984.³⁶¹ The FSC legislation was adopted by Congress in response to criticism of DISCs by the signatories of the General Agreement on Tariffs and Trade (GATT) who contended that DISC deferral amounted to an illegal export subsidy that violated the GATT rules. In an effort to approve a territorial type system of taxation for United States exports designed to comply with GATT, the FSC was adopted.

In 1999, the European Union claimed before the World Trade Organization (WTO) that the FSC legislation amounted to an export subsidy in violation of GATT Uruguay Round Code on Subsidies and Countervailing Duties. The WTO agrees with the EU's analysis of the FSC provisions, finding that they amounted to an export subsidy. The U.S. Congress responded by enacting the FSC Repeal and Extraterritorial Income Exclusion Act (ETI Act) of 2000. But in 2001, the EU challenged the new legislation as including a prohibited export subsidy. Again, the WTO adopted the EU's interpretation of the provisions and ruled the EU was entitled to impose retaliatory tariffs on U.S. imports. In 2004, President Bush signed the American Jobs Creation Act of 2004, which repealed the ETI Act, and instituted other tax breaks for businesses. FSCs were required to be incorporated outside the United States, within possessions of the United States qualifying for foreign-country status –

³⁵⁹ See *Traditional IRAs: Reporting Additional Taxes*, INTERNAL REVENUE SERV. (2012), available at <http://www.irs.gov/publications/p590/ch01.html> (For more information on the Individual Retirement Age.

³⁶⁰ See generally William L. Blum, *United States Virgin Islands Exempt Companies as Investment Vehicles*, FINDLAW (Mar. 26, 2008), <http://library.findlaw.com/2000/Oct/1/130151.html>.

³⁶¹ See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984), available at <http://www.irs.gov/pub/irs-tege/eotopica85.pdf>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

excluding the Commonwealth of Puerto Rico and select foreign countries with which the United States has an income tax treaty or Mutual Legal Assistance Agreement. Under the FSC legislation, the tax-exempt income was either 32% or 30% of the foreign trade income earned by the FSC at arm's length pricing or 1.83% gross sales up to 23% of the combined taxable income, whichever is greater.

To qualify as an FSC, a corporation was required to meet four major requirements: (1) to maintain a foreign presence; (2) to have economic substance; (3) to employ foreign management and economic processes giving use to foreign trading income; and (4) to use arm's length pricing methods.

XV. REBATES, BONDED WAREHOUSES, AND FREE TRADE ZONES

For the past two decades since the use of free trade zones became more popular, many people ask this question: "What is the difference between a free trade zone and a Customs-bonded warehouse?" Most Customs laws around the world have built-in provisions for bonded storage exemptions and the rebate of duties on materials used in re-exports.³⁶² The Customs-free benefits ordinarily operate in conjunction with a country's specific free trade zone aspirations. However, rebates based on re-exportation from a Customs Territory may be accelerated when goods are placed in a zone destined for export.³⁶³

Primarily because of lack of space or technology, bonded warehouse facilities do not offer such sophisticated services as assembly, processing, manufacturing, or even such less complex facilities as mixing, labeling, and other forms of minor manipulation. In addition, there are no restrictions or penalties for goods left at free trade zones for periods exceeding 90 days, as do exist in some bonded warehouses.³⁶⁴ Customs officials must make special visits to bonded warehouses in contrast to permanent assignments at free trade zones. Most free trade zones are created to attract commercial operations that otherwise would be carried out in other countries for Customs reasons. This is clearly seen in the savings from transshipment costs and time. In other cases, zones are established purely for their shelter plans when licensing operations may be carried out when processing or manufacturing is not feasible.³⁶⁵

XVI. CUSTOMS PRIVILEGES IN FREE TRADE ZONES, PRIVILEGED AND NON-PRIVILEGED STATUS OF GOODS, CUSTOMS FORMS AND PROCEDURES

Free trade zones serve mainly the United States, Canada, Mexico, the Far East, Latin America, the Caribbean area, and Europe. Subzones are special-purpose facilities for companies unable to operate effectively at public zone sites and are located at the zone user's private facility.³⁶⁶ Free trade zones are free of Customs duties and excise taxes on goods of

³⁶² See generally *Foreign Trade Zones vs. Customs Bonded Warehouses*, VT. GLOBAL TRADE P'SHIP (2012), <http://accd.vermont.gov/sites/accd/files/Documents/business/vgtp/ComparisonofFTZvsCBW.pdf>.

³⁶³ *Id.* at 2.

³⁶⁴ *Id.*

³⁶⁵ See *id.*

³⁶⁶ U.S. CUSTOMS PROCEDURES AND REQUIREMENTS, *supra* note 280.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

all description unless prohibited by law.³⁶⁷ For example, goods in free trade zones are exempt from internal revenue or state taxes on export whiskey, wines or other liquors. Goods benefit from recovery or drawback of duties previously paid on goods destined for export. All goods in free trade zones are free of import quotas and banking regulations. Allowance is made for recoverable and irrevocable waste; if recoverable waste is sent into Customs Territory, it is dutiable and taxable according to its condition, quantity, and weight at the time of entry.³⁶⁸ All imports leaving the zones for entry into the United States become subject to full Customs duties and excise taxes.

An important relaxation of the regulations was approved by the Treasury in March 1980 in an amendment to Section 146.48(E) of U.S. Customs regulations.³⁶⁹ Customs liberalized its policy so as not to assess duty on the costs of American labor, overhead and facilities, and the profit realized, when determining the dutiable value of articles produced entirely from foreign or domestic non-privileged merchandise or a combination of non-privileged and privileged merchandise (foreign or domestic) when articles leave a zone and enter United States Customs Territory. When companies get “non-privileged status” for their imports of foreign parts and components, no value is declared for Customs purposes at the time of entry into the zone, and the finished product is appraised by Customs upon completion of the product.³⁷⁰ Non-privileged status is preferable when parts and components are subject to a higher duty rate than finished goods.³⁷¹ The amount of the duties levied by Customs at the time the goods enter the Customs Territory is determined by the value and condition of the merchandise upon entry. To qualify for “privileged status,” the United States District Director of Customs must approve a permit based on an application submitted on Customs Form 214.³⁷²

In addition to the above “privileged” and “non-privileged” status of foreign merchandise, the Customs rules also provide for designation of goods as “privileged domestic merchandise” and “non-privileged domestic merchandise.”³⁷³ The former is used when domestic-origin goods or foreign merchandise previously imported duty-free or previously duty-paid are to be returned free of duty, quotas or taxes to the Customs Territory. Approval of an application on Customs Form 214 is possible even though the returned merchandise may have been incorporated into other products.³⁷⁴ “Non-privileged domestic merchandise” is treated similarly to “non-privileged foreign merchandise” in that the merchandise is eligible for “privileged domestic merchandise” status, but up to now there has been no application on Customs Form 214 approved by the District Collector of Customs. To get privileged status for merchandise, it is necessary under present regulations to apply to the District Director of Customs. Privileged status is granted when domestic or foreign components are recorded in a zone at the time they enter a zone, and they retain their “privileged” status unless in some way their identity is lost.³⁷⁵ Privileged domestic merchandise (including components) can return to

³⁶⁷ *See id.*

³⁶⁸ *See id.*

³⁶⁹ *See* Amendment to Section 146.48(E) of U.S. Customs Regulations, (Mar. 1980), *available at* <http://www.ftzcorp.com/ArticleDetails/tabid/210/ArticleID/12/Default.aspx>.

³⁷⁰ *A Brief History*, *supra* note 299.

³⁷¹ *Id.*

³⁷² Wyatt, *supra* note 301.

³⁷³ *Id.*

³⁷⁴ *Id.*

³⁷⁵ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

United States Customs Territory free of quota, duty, or tax, while privileged foreign merchandise (including components) is appraised on the date the application is filed with the District Director regardless of when merchandise leaves the zone and enters U.S. Customs Territory.³⁷⁶

“Zone restricted merchandise” is merchandise transferred to a zone from the Customs Territory for storage, or for the purpose of satisfying a legal requirement or destruction, and that merchandise is considered to have been exported and may not be transferred to Customs Territory for consumption unless the Foreign Trade Zones Board rules specifically state that it is in the public interest to do so.³⁷⁷ “Articles of mixed status” are those items transferred to the Customs Territory and composed of, or derived in part from, merchandise considered “privileged” and/or “non-privileged,” whether foreign or domestic.³⁷⁸

The articles are appraised according to the status of the merchandise of which they are composed or from which they are derived. Products that have benefited the most from the new law include vehicles (automobiles, motorcycles and snowmobiles), watches, typewriters, cameras, textiles, computers, television sets and parts, scientific and medical equipment, and electronics and audio equipment. On September 30, 1979, Customs simplified zone paperwork by replacing four old documents with three new ones and requesting a letter of application instead of a fifth document. The Customs Forms which must now be filled out are: No. 214 (Application for Foreign Trade Zone Admission and/or Status Designation), replacing Form B; No. 215 (Application to Constructively Transfer Foreign Trade Zone Merchandise), dealing with entry of goods into Customs Territory, replacing Form C; and No. 216 (Application for Foreign Trade Zone Activity Permit), specifying the types of activities, *i.e.*, such as manipulation, manufacture, exhibition, or destruction of merchandise to be performed in the zone, replacing Form E.³⁷⁹

A zone user is requested to write a letter of application containing the information formerly called for in Form F, which was an Application for a Certification of Foreign Trade Zone Privileged Merchandise, Foreign or Domestic, to be brought into Customs Territory.³⁸⁰ Zone operators and grantees are allowed to print their own letterheads at the top of Form 214. Foreign trade zones have become so important, in terms of both numerical growth and export processing, that the Bureau of Census has proposed amending its foreign trade statistics regulations to cover the movement of merchandise in and out of the zones. Heretofore export statistics have reflected the movement of merchandise into and out of Customs Territory and have excluded merchandise entering and leaving zones. In keeping with the Paperwork Reduction Act of 1980, no extra burden will be placed on the public.³⁸¹ Information on imports will be obtained from Customs Form 214, the regular form used by zone tenants applying for admission of merchandise into a zone, while exports will be reported on Form 7525V instead of Form 7513.³⁸²

³⁷⁶ *Id.*

³⁷⁷ *See id.*

³⁷⁸ U.S. CUSTOMS PROCEDURES AND REQUIREMENTS, *supra* note 280.

³⁷⁹ *See id.*

³⁸⁰ *See* FREE TRADE ZONE FORMS, *supra* note 288, at 56.

³⁸¹ *See* Paperwork Reduction Act, 44 U.S.C. §§ 3501-3521 (1995).

³⁸² *See* Forms, U.S. CUSTOMS & BORDER PROT. (2012), <http://www.cbp.gov/xp/cgov/toolbox/forms/>.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

XVII. SPECIFIC FUNCTIONS OF THE FREE TRADE ZONES

In the FTZ, goods may be imported, stored, sold, labeled, marked, displayed, exhibited, broken up, repacked, assembled, distributed, sorted, graded, cleaned, mixed with foreign or domestic merchandise, or otherwise manipulated, or manufactured, trans-shipped, or re-exported.³⁸³ In 1950, a legislative amendment of the 81st Congress expanded the 1934 FTZ Act to include manufacturing and exhibition.³⁸⁴ Grantees are “public utilities” organized for the purpose of establishing, operating, and maintaining foreign trade zones which are awarded grants by the United States Foreign Trade Zones Board to carry out the above purposes.³⁸⁵ Land must be leased, while buildings may be leased to operators or users who also may construct their own buildings on leased land. Customs facilities are available at all zones, but banking services are available only at a few zones. The grantees and/or zone operators are required to comply with pollution guidelines. Merchandise may be stored in a foreign trade zone until a quota on entry is removed, or it may be manufactured or manipulated in a zone into a product not subject to the quota. Merchandise under bond may also be transferred to a foreign trade zone from the Customs Territory for the purpose of satisfying a legal requirement to export or destroy the merchandise. For instance, merchandise may be taken into a zone to satisfy any exportation requirement in the Tariff Act of 1930, or an exportation requirement of any other federal law insofar as the agency charged with its enforcement deems advisable. Exportation or destruction may also fulfill requirements of certain state laws. Many products subject to an internal revenue tax may not be manufactured in a zone, including alcoholic beverages, products containing alcoholic beverages, perfumes containing alcohol, tobacco products, white phosphorus material, firearms, and sugar. Clocks and watch movements cannot be manufactured in a zone. Admission of explosives and other merchandise may be forbidden under regulations administered by various federal agencies.³⁸⁶

XVIII. BANKING EXCHANGE AND CREDIT STATUS OF THE FTZ

Despite the recent banking crisis necessitating bailouts in 2008, the United States banking system remains strong and stable. The Federal Reserve Bank System (the “System”) consists of a Board of Governors and 12 Federal Reserve District Banks with 24 branches. All national banks and some state banks are members of the System. State banks also are under the authority of State Banking Departments. National banks also must be members of the Federal Deposit Insurance Corporation (FDIC) which insures each deposit account up to \$250,000. State banks may become members of the Federal Deposit Insurance Association. The Federal Reserve Board and the 12 district banks act as Central Banks, controlling money and credit, fixing discount rates and handling the open market government security issues and foreign exchange rates and “swaps.” There are about 12,000 commercial banks with tens of thousands of branches spread across the country. Approximately 400 of these banks have foreign departments capable of handling or processing international transactions, including import-export financing, letters of credit, collections, acceptances, and other forms of docu-

³⁸³ U.S. CUSTOMS PROCEDURES AND REQUIREMENTS, *supra* note 280.

³⁸⁴ *A Brief History*, *supra* note 299.

³⁸⁵ See 19 U.S.C. § 81a.

³⁸⁶ U.S. CUSTOMS PROCEDURES AND REQUIREMENTS, *supra* note 280.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

mentation. Until the big recession in 2008 and even thereafter, the United States dollar has always been one of the most sought after currencies in the world. The dollar floats in the free market after having been devalued twice in December 1971 and February 1973. Exchange delays are up to one month and collections on export drafts generally are paid promptly. The U.S. Government has an excellent Standard and Poor's credit rating, even though it dropped from an AAA rating to an AA rating after the budget deficit crisis, on August 5, 2011.

XIX. FTZS ARE A REGULATED PUBLIC SERVICE UTILITY

Free trade zones exist to serve the public. In the United States, foreign trade zones are licensed by a federal agency and must be sponsored by a state or local public body. The latter, in turn, frequently assigns the operation of the facility to a private management or servicing company specializing in this type of operation. The Federal Foreign Trade Zones Board in Washington regulates the United States zones to make certain they function as "public utilities."³⁸⁷ All manufacturing activities must be cleared by the Board to determine whether they conflict with the public interest. The Board plays a continuous regulatory and monitoring role to insure the public utility function by receiving operational reports from zone grantees and in turn by submitting an annual report to Congress on zone activities.

To serve the public purpose as it is intended, a free trade zone should be administered as an integral part of the economic development program of the country or community where it is located. Only in this way can its services be intertwined with the other resources and incentives of the region's efforts to reduce unemployment, stimulate international trade, earn foreign exchange, and make a positive contribution toward the nation's trade and payments balances. More importantly, when a tax-free trade zone is used properly, the operational and tax savings to importers, exporters, and bankers all over the world can mean the difference between success and failure for international businesses.

XX. CONCLUSION

A. Are U.S. Foreign Trade Zones Increasing U.S. Exports and Employment?

Of the 3,500 free trade zones around the world, the United States leads in number with 277, plus more than 500 additional subzones. Most export activity is from the subzones. Another half dozen municipalities or local port authorities have made or are about to make applications for zones to the United States Foreign Trade Zones Board in Washington. There are more than 3,300 firms utilizing the foreign trade zones of the United States.³⁸⁸ Since 1978, the growth of United States zones leaped by more than 300 times to reach the \$693 billion total in handling of goods in 2008.³⁸⁹ In fiscal year 2008, exports from the general

³⁸⁷ *Responsibilities of the Zone Grantee*, supra note 122.

³⁸⁸ See *Foreign-Trade Zones Record Increase in Shipments*, SHORT TAKES: NEWS FROM THE INT'L TRADE ADMIN. (INT'L TRADE ADMIN., Washington, D.C.), 2008, at 1, available at http://trade.gov/press/publications/newsletters/ita_0110/shorttakes_0110.asp.

³⁸⁹ See *id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

purpose zones and subzones came to approximately \$40 billion.³⁹⁰ Exports decreased slightly after 2008 because of the global recession. In 2010, exports from U.S. foreign trade zones increased from 2009 and amounted to over \$34.8 billion.³⁹¹ But this amount is still only 2.6% of the total number of exports from the United States to foreign countries.³⁹² Some trade zone officials have predicted that manufacturing activity in foreign trade zones will quadruple in the next ten years. There has been a general but only small increase in zone export activity from 1990 to 2010 despite the original purpose of the zones which is to increase export activity in order to positively impact the U.S. economy. Thus, if foreign trade zones in the United States are due to increase, we must dramatically increase the amount of exports from these zones in order to positively impact the U.S. economy, as this export increase policy did for the Chinese economy in the recent past.

Generally, the amount of merchandise shipped into FTZs and exported out of FTZs into foreign countries has been increasing. In 2000, the combined value of shipments into U.S. general purpose zones and subzones totaled \$238 billion, compared to \$174 billion in 1999.³⁹³ Exports or shipments to foreign countries from facilities operating under FTZ procedures in 2000 amounted to \$15 billion, which is less than the number of exports from FTZs in 1999 because of a special change in Customs procedures for handling export activity related to space launches.³⁹⁴ Ten years later in 2010, the combined value of shipments into general-purpose zones and subzones totaled over \$534 billion, compared with \$430 billion in 2009.³⁹⁵ Exports or shipments to foreign countries from facilities operating under FTZ procedures in 2010 amounted to over \$34.8 billion, which is more than double the amount of exports from FTZs in 2000, and this amount does not include certain indirect exports involving FTZ merchandise that undergoes further processing in the United States at non-FTZ sites prior to export.³⁹⁶ Merchandise received into FTZs has increased steadily from 1990 to 2008, which had the largest number of total foreign and domestic status merchandise received into FTZs (almost \$700 billion). There was a dramatic drop in 2009 due to the general recession (\$410 billion), and this amount increased to \$510 million in 2010. Exports into foreign countries from U.S. foreign trade zones including general purpose zones and subzones remained steady in the range of \$10 billion from 1990 to 1994, increased to \$16 million in 1994 and remained

³⁹⁰ FOREIGN-TRADE ZONES BD., 72ND ANNUAL REPORT OF THE FOREIGN-TRADE ZONES BOARD TO THE CONGRESS OF THE UNITED STATES 4 (2011), available at <http://ia.ita.doc.gov/ftzpage/annualreport/ar-2010.pdf>. [hereinafter 72ND ANNUAL REPORT].

³⁹¹ See *id.* at Figure 2 (containing graph of all exports from FTZs from 1990 to 2010, showing a slow but steady increase in exports from 1990 to 2008, a dramatic decline in exports in 2009 due to the global recession, and an increase in exports in 2010).

³⁹² According to the U.S. Census Bureau, Foreign Trade Division Report on U.S. Trade in Goods-Balance of Payments (BOP) Basis vs. Census Basis (June 8, 2012), there were \$1,288,882 trillion dollars' worth of total exports in 2010 from the U.S. and according to the 72ND ANNUAL REPORT, *supra* note 390, at 4, there were \$34.8 billion dollars' worth of exports from foreign trade zones in the US. Therefore, the ratio of FTZ exports to total exports from the U.S. is 2.6 %. In 2011, the number of total exports from the U.S. was \$1,497,407 trillion dollars, which is a slight increase in total exports from the previous year.

³⁹³ FOREIGN-TRADE ZONES BD., 62ND ANNUAL REPORT OF THE FOREIGN-TRADE ZONES BOARD TO THE CONGRESS OF THE UNITED STATES 2 (2000), available at <http://ia.ita.doc.gov/ftzpage/annualreport/ar-2000.pdf>. [hereinafter 62ND ANNUAL REPORT].

³⁹⁴ *Id.*

³⁹⁵ 72ND ANNUAL REPORT, *supra* note 390, at 1.

³⁹⁶ *Id.* at 2.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

in that range until 2000 when there was a decrease to \$15 billion.³⁹⁷ Exports have increased steadily from 2001 and dramatically in 2008 to \$40 billion. In 2009, there was a drastic decrease in exports to \$27 billion, and an increase in exports to almost \$35 billion in 2010.

Let us put these impressive statistics in perspective and see if the FTZs have actually positively impacted the U.S. economy by increasing exports and decreasing unemployment. Of the \$1,288,882 trillion of total United States exports in 2010,³⁹⁸ \$34.8 billion worth of exports came from U.S.FTZ zones, which is a actually only a meager 2.6 % of total exports. Nevertheless, the average amount of goods going through all of the world's foreign trade zones today exceeds 40%. In certain industrial countries that do not depend upon exports solely to survive, the percentage is even higher. For example, 60% of Germany's \$560 billion of exports go through the five free ports of Bremen, Bremerhaven, Cuxhaven, Emden, and Hamburg. In the developing countries, where the primary goal is to increase export earnings through the help of free trade zones, virtually all new zones in recent years have been export processing zones.

The recent trend in the United States is toward development of export processing zones to absorb unemployment in depressed areas as well as to expand export shipments to help reduce the trade deficit. More than 340,000 persons were employed in the United States zones in 1999.³⁹⁹ In 2009, approximately 330,000 persons were employed at some 2,500 firms operating under FTZ procedures.⁴⁰⁰ In 2010, approximately 320,000 persons were employed at some 2,400 firms operating under FTZ procedures.⁴⁰¹

Many of the zones established since 1970 have failed to live up to expectations. It is estimated that 10% of general purpose zones account for 90% of shipments through United States foreign trade zones, and that 35% of subzones handle all subzone traffic. Moreover, the value of zones as a boost to United States exports has been challenged. In general purpose zones, between 1983 and 1985 exports fell to 33% of total shipments handled, compared to 45% previously. Subzones fared little better, with exports as a percentage of total goods handled falling to 11% from 16%. In 2010, the ratio of total U.S. exports to exports from U.S. FTZ zones is 2.6%.⁴⁰² Therefore, the zones do not appear to be boosting U.S. exports.

Questions have also been raised about the practice of locating a new zone close to an established one. At the public hearing on the proposed Santa Ana zone, Long Beach (No. 50) expressed opposition to a zone only 20 miles away and contended that, if a zone is needed to service high-tech firms in Orange County, the zone should be an adjunct to No. 50 rather than a totally new operation.⁴⁰³ Objections were raised concerning whether Salem, New Jersey should establish a zone only 40 miles from Philadelphia. Some zones are improving profits by deactivating warehouse space from zone limits and by allowing non-zone users to take advantage of zone facilities while still observing federal regulations. John DaPonte, the for-

³⁹⁷ *Id.* at 4, Figure 2.

³⁹⁸ U.S. CENSUS BUREAU, *supra* note 392.

³⁹⁹ See 62ND ANNUAL REPORT, *supra* note 393, at 2; see also Puccinelli, *supra* note 199, at 1.

⁴⁰⁰ See 70TH ANNUAL REPORT, *supra* note 159, at 2.

⁴⁰¹ See 72ND ANNUAL REPORT, *supra* note 390, at 2.

⁴⁰² For an explanation, see *supra* note 392.

⁴⁰³ See G.M. Bush, *Success Elusive for Free Trade Zones Santa Ana Officials Stress the Differences in Their Plan*, L.A. TIMES, May 2, 1985, http://articles.latimes.com/1985-05-02/business/fi-20413_1_import-duties.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

mer executive secretary of the Foreign Trade Zones Board, has urged establishment of more subzones to help a faltering zone.⁴⁰⁴

Unlike most of the export processing free trade zones of the developing countries, the foreign trade zones in the United States generally are involved with warehousing, labeling, assembling or distributing operations instead of export processing. Less than a dozen of America's zones presently transform property by processing or manufacturing, and the trend now is for companies to take advantage of processing and manufacturing features with considerably less emphasis on storage and simple bonded warehousing. In fact, the grantee of New York Foreign Trade Zone No. 1, the City of New York, has considered the establishment of subzones where domestic and foreign companies processing or manufacturing for export would be granted New York City and State income and other tax exemptions if they employ a specific number of workers and invest a designated amount of capital in their free trade zone operations.

Although legislation to establish foreign trade zones in the United States was first introduced in 1894, strong opposition by "protectionist" advocates held up their establishment until 1933 when the Foreign Trade Zone Act of 1934 was passed. In 1950, the Boggs amendment permitted manufacturing and exhibition in foreign trade zones.

Every port of entry to the United States is entitled to establish a foreign trade zone by grant, in conformity with the U.S. Code of Federal Regulations, Title 15.⁴⁰⁵ Operation of a zone is regulated in Title 19, dealing with Customs Service.⁴⁰⁶ The District Director of Customs in whose district the zone is located is in charge of the zone as the local representative of the Foreign Trade Zones Board. With regard to merchandise, the District Director controls its entry into the zone, handling and disposition within the zone, and removal from the zone. In addition to the U.S. Foreign Trade Zones Act, the District Director of Customs enforces all laws normally enforced by the Customs Service which are relevant to foreign trade zones. Zones are supervised by United States Customs officers whose salaries are reimbursed to Customs by the zone grantee. The security of the zone must meet United States Customs requirements.⁴⁰⁷

Grants are bestowed by the United Foreign Trade Zones Board, which is chaired by the U.S. Secretary of Commerce; Board members include the Secretaries of the Treasury and Army.⁴⁰⁸ Day-to-day administration is conducted by the Board's Executive Secretary, who is appointed by the Secretary of Commerce, and who operates from an office in the U.S. Department of Commerce, Washington, D.C. 20230. The Board may approve any zone or subzone which it deems necessary to adequately serve "the convenience of commerce."⁴⁰⁹ Besides considering applications to establish zones, the Board regulates their administration and the rates charged by zone grantees.

⁴⁰⁴ John J. DaPonte, Jr., *The Foreign-Trade Zones Act: Keeping Up with the Changing Times*, BUS. AMERICA (December 1997), available at <http://www.millerco.com/pdfdocuments/ftzact.pdf>.

⁴⁰⁵ See generally 15 C.F.R. (2012).

⁴⁰⁶ See generally 19 C.F.R. (2012).

⁴⁰⁷ Information about Customs Regulations can be obtained from the District Director of Customs for the zone or from U.S. Customs Service Headquarters, Washington, D.C. 20229, Attention: Drawback and Bonds Branch.

⁴⁰⁸ See 15 CFR § 400.23 (2012).

⁴⁰⁹ See *id.* § 400.21.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Because of the rapid increase in the number of United States foreign trade zones from a mere seven in 1970 to more than 277 general purpose zones and 500 special purpose subzones in 2011, the 78-year-old program has generated much controversy in Congress. As a result of their tremendous growth from less than \$100 million of annual turnover to more than \$90 billion within a 21-year span, the House Ways and Means Committee asked the General Accounting Office (GAO) and the International Trade Commission (ITC) to prepare reports on where the program was going. The House Ways and Means Committee asked these two agencies to determine whether the program is meeting the “Congressional intent” of promoting United States economic development, exports, and employment. In fact, many Congressmen have been concerned about the acceleration in the approval of sites by the Foreign Trade Zones Board. The ITC report concluded that many of the jobs created by zones existed before zone status was achieved, and some plants had been built only because of the availability of lower tariffs. Congress is urged to re-examine the existing law because it does not require the Zones Board, when ruling on applications, to evaluate the impact of a zone on the United States economy, individual industries, and imports. More severe in its attitude, the GAO claimed that the zones have failed in their original purpose of encouraging United States exports, and that 90% of products passing through the zones are eventually sold in the United States. The real answer to the zone enigma, which simultaneously could play a vital part in reducing the United States trade deficit through export expansion, is to implement a revision in U.S. present legislation that would require a minimum of 60% to 70% of zone activity to be devoted to export processing. Several zones are located within a few miles of each other. The question is whether they are really fulfilling their purpose to expand and facilitate United States trade.

Another General Accounting Office survey conducted in 1993, and related to the increasing number of labor critics and Congressional critics of the U.S.AID programs, confirmed that American taxpayer money had been used to facilitate the shifting of United States manufacturing jobs abroad by providing financial assistance to foreign export processing zones. The GAO survey claimed that the private sector zones are the most successful.⁴¹⁰ In the ten-year period 1983–1993, U.S. AID provided \$69 million to private groups in El Salvador, Dominican Republic, Honduras, and Costa Rica that promoted the benefits of investing in export zones of U.S. companies abroad.⁴¹¹ U.S.AID granted more than \$250 million in loan capital to finance investments in these countries.⁴¹² It was also revealed that the Overseas Private Investment Corporation insured investments of these companies amounting to \$43.2 million.⁴¹³ Other agencies supporting these investment ventures with assistance were the Export-Import Bank and the State and Commerce Departments. In response to the negative impact on the American economy of outsourcing and manufacturing overseas in export processing zones, the Omnibus Budget Reconciliation Act of 1993 prohibited the use of U.S.AID funds to help export processing zones overseas.⁴¹⁴

Pressure is growing to restrict the use of zones and subzones, but it is unlikely that the pace of new zone approvals will slow down in the future. To date, the Caribbean Basin

⁴¹⁰ See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-94-31, FOREIGN ASSISTANCE: U.S. SUPPORT FOR CARIBBEAN BASIN ASSEMBLY INDUSTRIES (1993), available at <http://www.gao.gov/assets/160/154093.pdf>.

⁴¹¹ *Id.* at 4.

⁴¹² *Id.*

⁴¹³ *Id.* at 31.

⁴¹⁴ See generally Omnibus Budget Reconciliation Act of 1993, H.R. 2264, 103rd Cong. (1993-1994).

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

Initiative has not hurt business at southern seaport zones as expected, although this program allows duty-free entry into the United States for exports from 27 Caribbean nations, thereby diminishing the zones' most important special inducement.

In 1989, pressure from the United Auto Workers, the Automotive Parts and Accessories Association, Midwest parts companies, and steel industry lobbyists, as well as several members of Congress, led to a decision by the House Ways and Means Committee to hold hearings on the proliferation of United States foreign trade subzones.⁴¹⁵ In the 170 subzones existing in 1987, 55 foreign and American automotive companies did business in these zones. Automotive parts and components represented 80% of the more than \$7 billion of all parts that flowed through United States zones in 1986.⁴¹⁶ This compares with only \$900 million parts entering the zones in 1979.

A demand for reforms in the establishment and supervision of subzones was voiced by the Automotive Parts and Accessories Association, which supports the 1989 General Accounting Office Report. The Automotive Parts and Accessories Association charged that subzones led to a loss of 14,000 jobs in the United States automotive components industry and that, instead of boosting exports, subzones benefit users who import more parts. The controversy over the actual effect of zones and subzones on the United States economy, and exports in particular, led the Commerce Department in 1991 to draft comprehensive new rules that expedite the authorization process employed by the U.S. Foreign Trade Zones Board. Additional changes were proposed in 2012.⁴¹⁷

Washington officials estimated that 75% of the goods (received and shipped) passing through trade zones actually end up in United States products that are assembled in America and imported back into America. During the five-year period from 1986 to 1991, the number of U.S. foreign trade zones at airports doubled as municipal port authorities turned to zones to capture more foreign trade business. The old perception that a foreign trade zone had to be on a navigable waterway to be successful no longer holds true. The volume of cargo leaving zones for domestic and overseas markets and arriving back in United States zones represents the fastest area of growth. Opponents of the subzones believe that the huge quantity of foreign component parts imported into U.S. foreign trade zones takes away American jobs and does not actually increase the number of exports of cars from the United States.

In 2012, "Paul Piquado, Assistant Secretary for the Import Administration at the International Trade Administration . . . announced the first regulatory overhaul to the Foreign Trade Zone (FTZ) program in 20 years."⁴¹⁸ The FTZ Board

issued new regulations designed to improve the FTZ program's flexibility and responsiveness, enhance ease-of-use for applicants, and promote even greater transparency for both stakeholders and the public. . . . The new regulations replace the prior manufacturing-approval procedures with a . . .

⁴¹⁵ See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-89-85, FOREIGN TRADE ZONES PROGRAM NEEDS CLARIFIED CRITERIA (1989), available at <http://www.gao.gov/assets/150/147348.pdf> [hereinafter PROGRAM NEEDS CLARIFIED CRITERIA].

⁴¹⁶ *Id.* at 16.

⁴¹⁷ FOREIGN-TRADE ZONES BD., PREAMBLE COMMENTS AND DISCUSSION OF 2012 PROPOSED CHANGES (April 30, 2012), available at <http://ia.ita.doc.gov/ftzpage/grantee/preamble.html>.

⁴¹⁸ *FTZ Regulation Revision Promotes Flexibility, Transparency*, GLOBAL CAROLINA BUS. J. (Feb. 23, 2012), http://gcbusinessjournal.com/index.php?option=com_content&view=article&id=1706:ftz-r.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

simpler and faster standard notification process, . . . [reducing] the ordinary processing time for notifications to 120 days.⁴¹⁹

This report claims that FTZs in the U.S. export approximately \$30 billion a year in merchandise.⁴²⁰ The regulations support President Obama's National Export Initiative

by enabling U.S. manufacturers to compete more effectively for global export business. Rather than continuing to require advance approval by the FTZ Board, the . . . regulations . . . allow a company manufacturing for export to simply report its FTZ activity at the [end of the] year. This change [could] dramatically improve the flexibility and responsiveness of the FTZ program for U.S. exporters.⁴²¹

The National Association of Foreign-Trade Zones released a report on July 18, 2012, claiming that there has been "impressive growth in merchandise received in, and exports from, foreign-trade zones [which] outpaced comparable growth in the overall U.S. economy as the nation struggled to recover from the depths of recession in 2009-[20]10."⁴²² The FTZ exports that totaled \$34.8 billion are actually "a 23-percent increase that outpaced the 16 percent growth in exports generated by the overall U.S. economy"⁴²³ Daniel Griswold, the President of NAFTAZ, said, "Export growth is a critical component for our national economic recovery, . . . [t]his report documents how market-leading firms are using the foreign-trade zone tool to boost exports and profits despite continued sluggish economic conditions."⁴²⁴ The state of Texas led all states in the value of merchandise received into FTZs (\$161.1 billion), the number of firms operating in zones (393), the amount of zone exports (\$7.2 billion), and employment (51,085).⁴²⁵ In Texas, the foreign-trade zones help create jobs and increase exports.⁴²⁶ "The international automotive sector led the way with \$11 billion worth of FTZ exports in 2010."⁴²⁷ FTZs actually help auto companies "access parts and raw materials around the world at more competitive prices, [thereby] reducing costs and making the United States a more competitive location for manufacturing motor vehicles for domestic sale and [for] export."⁴²⁸ Further,

U.S. Department of Commerce figures released on July 11, [2012] indicate that automotive exports continue to outpace overall export growth. . . [W]hile exports of all goods from January to May 2012 (\$649.9 billion)

⁴¹⁹ *Id.*

⁴²⁰ *Id.*

⁴²¹ *Foreign Trade Zones Enhance U.S. Competitiveness, Grow Economy*, GLOBAL CAROLINA BUS. J. (Jan. 3, 2011, 8:58 AM), http://gcbusinessjournal.com/index.php?option=com_content&view=article&id=859.foreign.

⁴²² *Foreign-Trade Zones A Bright Spot in U.S. Economic Recovery, Study Shows*, NAT'L ASS'N OF FOREIGN-TRADE ZONES (July 18, 2012, 2:47 PM), <http://news.cision.com/national-association-of-foreign-trade-zones/r/foreign-trade-zones-a-bright-spot-in-u-s--economic-recovery--study-shows,c9285757>.

⁴²³ *Id.*

⁴²⁴ *Id.*

⁴²⁵ *Id.*

⁴²⁶ *Id.*

⁴²⁷ *Id.*

⁴²⁸ *Id.*

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

grew by 5.9 percent from the comparable period in 2011 (\$611.4 billion), exports of automotive vehicles, parts and services grew by 14.3 percent, from \$53.4 billion to \$61.0 billion . . . [and] much of this export activity is FTZ-related.⁴²⁹

Thus, when foreign trade zones are used strategically, they can increase U.S. manufacturing and U.S. exports and impact the U.S. economy positively.

B. Disadvantages of U.S. Foreign Trade Zones and Free Trade Zones of the World

Various studies by the United States International Trade Commission (ITC) and the General Accounting Office (GAO) indicate that zones, particularly subzones, appear to be working against America's economic interest. Furthermore, the studies show that zone growth is distributed among a few zones, while many others are idle. According to the GAO, in 1986 tariff reductions through United States zones amounted to \$38 million, largely for automotive parts that were assembled into completed automobiles for the United States market by American subsidiaries of foreign companies.⁴³⁰ Foreign parts imported by subzones increased ten-fold in the 1982–86 period, with Japan sourcing 70% of that total. In 1987, the United States ran a deficit of more than \$14 billion in auto parts. According to ITC, only one-tenth of zone shipments represent exports of trans-shipments to foreign ports.

Other studies are surfacing that tend to support the contention that some zones, in particular those involved in automobile production, have brought severe hardships to local communities and various interest groups. A United Auto Workers study concludes that for every assembly line job at a United States-owned car factory in the United States, 13 other jobs are created outside the plant and benefit the U.S. economy. In contrast, for every job in a newly built Japanese plant, only three out of four new jobs are created. Therefore, the use by American subsidiaries of foreign companies to manufacture cars in U.S. foreign trade zones has reduced the amount of jobs in the automotive industry.

Labor conditions and practices in the U.S. foreign trade zones as well as the labor practices by U.S. companies manufacturing abroad in free trade zones have been highly criticized. Labor abuses in U.S. companies in Mexican *maquiladoras* are legendary, and sweat-shop conditions still persist there. Another recent example is Apple Inc. which is a U.S. company that has been accused of egregious labor abuses in China. Apple contracts with original equipment manufacturers in China such as Foxconn, whose largest factory is located in Longhua, Shenzhen (a free port city), where 230,000 Chinese workers are employed in what is referred to as "Foxconn city". Apple's Foxconn factories have been evaluated and highly criticized in a report by Debby Chan, Project Officer of the Hong Kong based "Students and Scholars Against Corporate Misbehavior". This report found serious labor abuses in Apple's

⁴²⁹ *Id.* See also Press Release, U.S. Bureau of Econ. Analysis, U.S. International Trade in Goods and Services, U.S. Dep't of Commerce (Sept. 11, 2012), available at <http://www.bea.gov/newsreleases/international/trade/2012/trad0712.htm>; NAT'L ASS'N OF FOREIGN-TRADE ZONES, THE IMPACT OF FOREIGN-TRADE ZONES ON THE 50 STATES & PUERTO RICO 2 (2012), available at <http://www.rochesterbiz.com/Data/Documents/2009%20State-byState%20FY%202007%20%28Final%20Copy%29.pdf>.

⁴³⁰ See PROGRAM NEEDS CLARIFIED CRITERIA, *supra* note 415.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Foxconn factory, and the report was issued on March 29, 2012.⁴³¹ Apple has easy access to the Chinese supply chain because of its location in the factory in the free port city of Shenzhen. Because of the criticism and negative publicity Apple has received about allegedly exploitative labor practices in its Foxconn factories, Apple has agreed to make serious labor reforms in order to benefit the many Chinese Foxconn employees on the production line in Shenzhen.⁴³²

Another example of bad labor practices by foreign companies using American foreign trade zones is a Japanese company in Smyrna, Tennessee. Calling for a national policy regulating corporate–state negotiations to attract foreign subsidiary plants, some observers point to costly incentive programs and alleged “white-only” hiring practices as growing economic bad practices. One report reveals that when Nissan first set up its plant in Smyrna, Tennessee, the incentives granted to the manufacturer amounted to \$11,000 for each worker.⁴³³ For the Subaru plant in Lafayette, Indiana, the incentive package cost \$50,000 per employee.⁴³⁴ The study warns that incentive costs may triple when the states retire the revenue bonds they issued to finance the transactions. Aside from the financial burden, some say other shortcomings include exclusion of organized labor in negotiations and environmentalists in site selection, and a penchant for hiring local, predominately white, residents to the exclusion of minority workers, who tend to live in large cities. Free trade zones are reportedly a haven for money launderers, smugglers, and drug traffickers.⁴³⁵

Zones have come under attack from other quarters. In August 1990, the United States Court of Appeals in Atlanta, Georgia overturned a District Court ruling that would have permitted the Florida Department of Health and Rehabilitation Services to insist that a pharmaceutical trans-shipper be licensed as a drug wholesaler. The company, 3M Riker, a British subsidiary of 3M Corporation, uses the Port Everglades Zone (No. 25) as a site for shipping pharmaceuticals produced by other 3M subsidiaries to Latin America. The Florida agency intended to enter the zone to inspect 3M Riker for compliance with the State’s Drug and Cosmetic Act, even though the goods, most of which are not approved for use in the United States, never enter the United States market. The District Court agreed with Florida’s position, but the Appellate Court did not. In earlier cases, the U.S. Supreme Court ruled that ad valorem taxes could not be levied on copy machines stored in a zone’s bonded warehouse

⁴³¹ Debby Chan, Project Officer, Students & Scholars Against Corporate Misbehavior, Presentation at A Closer Look at Apple and Foxconn: Labor Practices in China and Brazil (April 11, 2012), *available at* www.epi.org/event/apple-foxconn-labor-practices-china/#materials.

⁴³² Henry Blodget, *Your iPhone was Built, In Part, By 13 Year-Olds Working 16 Hours a Day*, BUS. INSIDER (Jan. 15, 2012, 10:20 AM), www.articles.businessinsider.com/2012-0; *see also* *Work Conditions Said to Improve at Apple Supplier*, N.Y. TIMES, Aug. 23, 2012, at B7. Protests against Hong Kong and Chinese bosses in Bangladesh who pay workers low wages (\$50 a month) and want further cuts in wages broke out in violence in an Indian Export Processing Zone in Bangladesh, India, now an export powerhouse for apparel exports to the United States and Europe, second only to China. *See* Jim Yardly, *Export Powerhouse Feels Pangs of Labor Strife*, N.Y. TIMES, Aug. 24, 2012, at A1.

⁴³³ H. Brinton Milward & Heidi H. Newman, *State Incentive Packages and the Industrial Location Decision*, 3 ECON. DEV. Q. 203, 211-213 (1989).

⁴³⁴ Susan Pastor, *Fuji, Isuzu Plan U.S. Auto Plant*, N.Y. TIMES, Dec. 3, 1986, at D1.

⁴³⁵ *See* FIN. ACTION TASK FORCE, MONEY LAUNDERING VULNERABILITIES OF FREE TRADE ZONES (March 2010), *available at* <http://www.fatf-gafi.org/documents/documents/moneylaunderingvulnerabilitiesoffreetradezones.html>.

U.S. FOREIGN TRADE ZONES, TAX-FREE TRADE ZONES OF THE WORLD

while awaiting export. However, in another case the U.S. Supreme Court allowed taxation of tobacco stored in bonded warehouses prior to entry into the domestic marketplace.

Therefore, the free trade zones of the world and the foreign trade zones in the United States have been criticized for many reasons including bad labor practices, environmental abuses, the failure to increase exports sufficiently, and the liberal use of zones by money launderers and narcotics traffickers.

C. Advantages of U.S. Foreign Trade Zones and Free Trade Zones of the World

Despite the avalanche of attacks on foreign trade zones, there are some United States auto manufacturers, as well as the Motor Vehicle Manufacturers Association, who maintain that the automotive subzones help American companies compete with foreign imports. They say it is the single most effective means to reduce the cost of manufacturing automobiles in America.⁴³⁶ Since tariffs on assembled cars coming into the United States from a U.S. subzone are reduced to 2.5% on the final product, compared with an average of from 4% to 11% on the imported parts, the saving on each assembled U.S. subzone car comes to about \$5 on a small car and as much as \$8 on a larger vehicle.⁴³⁷ For companies producing approximately 200,000 cars annually, the economic benefit of manufacturing in U.S. foreign trade zones could amount to a substantial additional profit of \$1.6 million annually. Japanese producers of American-made cars, who are more dependent on imported parts than the “Big 3” of the U.S., report a savings of \$35 per car by using a U.S. zone.⁴³⁸

A number of United States companies are convinced that general purpose zones and subzones encourage establishment of factories in the United States that help reduce the massive trade deficit and also help create new jobs for American workers. Nevertheless, the consensus is that the support for protectionism in Congress is sufficient to inspire some curtailment of the scope of the Foreign Trade Zones Act of 1934, as amended in 1959. In the Congressional hearings of 1999, the House Ways and Means Committee relied heavily on two new foreign trade zone studies, one by the General Accounting Office and the other by the International Trade Administration. Previous studies prepared by these two Government agencies were not conclusive as to the overall advantages and disadvantages of free trade zones and foreign trade zones to the United States economy.

In April 1988, the United States Department of Agriculture (USDA) asked the Commerce Department to take steps to standardize regulations affecting the use of imported sugar in foreign trade zones. The USDA, concerned that zones were being used to get around United States sugar import quotas, said that American companies in five zones and two subzones were importing lower-priced world sugar for manufacturing purposes. The USDA wanted a ban on manufacturing sugar-containing goods for export under both USDA’s re-export program and zone procedures. USDA also wanted the U.S. Commerce Department to standardize regulations covering sugar in zones and subzones. The re-export program allows United States manufacturers to import sugar in excess of quota limitations if items using the

⁴³⁶ See David Ostheimer, *FTZs are Valued as Vehicle Processing Centers*, GA. FOREIGN-TRADE ZONE (2007), <http://www.georgiaftz.com/case-studies>.

⁴³⁷ See Deborah L. Swenson, *Explaining Domestic Context: Evidence from Japanese and U.S. Automobile Production in the United States*, in *THE EFFECTS OF U.S. TRADE PROTECTION AND PROMOTION POLICIES* 33, 36 (Robert C. Feenstra ed., 1995), available at <http://www.nber.org/chapters/c0308.pdf>.

⁴³⁸ *Id.* at 33-34.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

sugar are exported within 18 months. USDA wanted firms taking advantage of the re-export program to be limited to the program and excluded from zone procedures. When manufacturers use both the re-export program and zone procedures, USDA claimed it has a difficult time monitoring whether too much sugar is staying in the United States.

A number of Customs and Internal Revenue Service rulings and interpretations are likely to have a far-reaching impact on the use of America's foreign trade zones in the future. Since 1984, Customs has regarded merchandise temporarily imported into the U.S., subsequently processed, and then moved into a zone for manufacturing into a different product as having been "exported." Because of complaints from the influential steel and automotive associations and institutes, Customs is under pressure to change the interpretation in order to discourage imports of these highly competitive products. Another ruling by Customs facilitates the shipping of goods into the United States island possessions with duty-free benefits. With reliance on the "double transformation concept," foreign raw materials and components processed in the Virgin Islands, Guam, American Samoa, the Northern Mariana Islands and the other important insular possessions are now treated as having originated in one of these islands for determination of local value content. The Internal Revenue Service has now issued temporary regulations establishing new rules for use of foreign currencies in their international transactions. Companies with overseas subsidiaries using the net worth method of accounting in a currency other than the United States exchange are now faced with additional obstacles as the currencies must be translated into the profit-and-loss method.

Importers in the United States are learning that compliance with the Harmonized Customs Code effective as of January 1, 1989 as a result of the Omnibus Trade Act of 1988 is easier than anticipated.⁴³⁹ The universal international commodity classification schedule, finally adopted by United States businesspeople following official sanction, has developed fewer bottlenecks than expected because American companies had been well prepared for its arrival. Customs attorneys believe that employees of the Treasury's Customs division have had to invent a system as they went along since there were no guidelines from the courts. Now rulings are issued monthly on product classification since the new "essential character" criterion that replaced the "chief value" criterion has created some question on the classification of goods.

This article has shown that there are conflicting reports on the advantages and disadvantages of free trade zones and U.S. foreign trade zones and their impact on the U.S. economy. Moreover, it is undeniable that there are multiple causes of the global recession, and tax-free trade zones may be, at best, one of the minor causes. In order for the tax-free trade zones to do what they were intended to do, that is to increase exports, facilitate constructive international trade, and enhance international business, we must make sure, through rational and reasonable regulatory schemes, that the zones are being used for the primary purpose of increasing exports and safeguarding social and environmental standards both here and abroad.

⁴³⁹ See Omnibus Trade Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (1988) (codified at 19 U.S.C. § 2901).