TRADE AND CUSTOMS SERVICES

Comparative Review of Select Free Trade Zones around the World

TAX

In today's economy, companies are looking for opportunities to improve efficiency and increase bottom-line savings. Just a little over a year ago, these companies continued on their path to becoming evermore global and tapping into the benefits of global supply chains. Today they need to look globally for efficiency and cost savings.

Customs and logistics expenses relating to the import and export of finished goods and raw materials, which have been generally considered to be unavoidable costs of doing business, are now coming under closer scrutiny. In today's world of global supply chain operations, where goods are sourced, manufactured, and sold in multiple countries, companies need to establish comprehensive saving strategies encompassing not only import-export operations in the United States but also abroad.

One effective way of achieving both supply chain efficiency and cost savings is by implementing a Free Trade Zone, or Foreign Trade Zone (collectively, FTZ), at a company's distribution or manufacturing facility location. Historically available in most countries around the world, FTZs are some of the most beneficial, yet underutilized regimes for realizing saving on duties, taxes, and other costs involved with global trade. What is more, FTZs are by no means a program used exclusively in one country, such as the United States. In fact, because most countries have FTZ programs, companies may use FTZs (or similarly designated areas) in various global locations to attain all or some of the primary FTZ benefits listed below:

- *Duty Deferral* – Import duties for imports shipped to an FTZ are deferred until the time those products leave the FTZ and enter countries' commerce.
- *Duty Exemption* – Import duties are exempted for imports entering an FTZ and later exported without ever entering countries' commerce or destroyed within the FTZ.
- *Duty Reduction (Inverted Tariff)* – Importers who import raw materials and conduct manufacturing operations in an FTZ may elect to pay duties for imported raw material based on the duty rate of the manufactured item (when the duty rate for the item is lower than the raw material duty rate) at the time the manufactured product leaves the zone and enters countries' commerce.

While these are the primary benefits of operating in an FTZ in most countries, particular countries may provide additional incentives and may have different requirements for the use of FTZs. Highlighted as follows are the benefits of FTZ programs in a few key countries, where many companies today concentrate manufacturing, assembly, or distribution operations.

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United States

In the United States, an FTZ is a secure area located in or near a port of entry that is considered outside the U.S. Customs and Border Protection (CBP) territory. Companies may also designate their own manufacturing or distribution centers as an FTZ anywhere in the United States and Puerto Rico. There are currently more than 260 such areas designated as FTZs, which offer services to more than 2,500 FTZ users nationally. The designation of an FTZ requires application to the U.S. Foreign Trade Zones Board and subsequent implementation of policies, procedures, and systems.

In addition to duty deferral, exemption, and reduction benefits, FTZs in the United States also offer the following incentives:

- *Zone-to-Zone Transfers* – A vendor located at one FTZ may sell goods to a company in another FTZ and/or transfer those goods to the purchasing company's FTZ with no import duty paid on the goods.
- *No Duty on Value Added* – When manufacturing operations are performed within an FTZ, no duties are assessed on domestic parts, materials, labor, and profit.
- *Reduction on Broker and Processing Fees* – Because importers using FTZs are allowed to file weekly Customs entries, transaction costs relating to broker and merchandise processing fees are also reduced.
- *Exemption of Inventory Taxes* – Inventory maintained within an FTZ is exempt from personal property taxes in states where this tax is applicable.
- *Enhanced Processes* – Because the running of an FTZ requires strict inventory controls, processes around these controls often lead to increased security, CBP compliance, and supply chain improvements. One primary supply chain enhancement is the ability to import products under direct delivery procedures; imported items are not subject to CBP approval until after the product arrives in the FTZ, reducing the likelihood of cargo delays from CBP inspections at the port of arrival.

Viable candidates for using FTZs are importers with high transaction volume that can take advantage of the "weekly entry benefit"; importers that perform significant manufacturing or assembly in which the finished product has a lower duty rate than the duty rate of the imported materials; industry segments where importing is critical, including footwear, apparel, electronics, chemical, automotive, component subassemblies, and petroleum; and companies that want to shift operations to, or continue them in, the United States and defer, reduce, or eliminate Customs duties and fees payments on imported goods.

European Union

Companies operating distribution or manufacturing facilities may also greatly benefit from the various types of FTZ regimes available in the 27 countries of the European Union (EU). A primary FTZ program, called Processing under Customs Control (PCC), is an arrangement within the EU similar to the U.S. FTZ concept. This regime is provided for in Council Regulation (EEC) 2913/92 establishing the Community Customs Code and in Commission Regulation (EEC) 2454/93. Similarly, import value added tax (VAT) relief is provided for in the EU VAT Directive.

It is these regulations that allow importers to place goods under PCC arrangements for further processing within the EU and to pay a lower amount of customs duty based on the same inverted tariff rule executed in the United States. However, in determining whether this regime is suitable for a company's operations, it is important to note that when the goods are discharged from PCC, their value is deemed to be the customs value of the goods entered into PCC plus the value of any other materials added, labor costs, and other directly attributable overheads. Therefore, the applicant will need to calculate whether the charges due on this increased value—albeit at a lower rate—exceed those that would have been due on the imported goods alone.

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Benefits of operating under PCC not only include the potential lower duty rate, but also the temporary suspension of VAT, agricultural levies, and other Common Agricultural Policy charges.

PCC is available for businesses established within the EU; however, use of this regime requires prior authorization from the local customs authorities. There are several different types of authorizations (i.e., local, community, simplified, or integrated) that a company may apply for depending on your requirements and operating structure.

In cases where exceptional circumstances can be proven, retrospective approvals can be obtained to allow importers to reclaim duties paid during the approved period. The European Court of Justice has defined exceptional circumstances to be those that "although not unknown to the trader are not events which would normally confront any trader in the exercise of his business or circumstances which are liable to put the applicant in an exceptional situation in relation to other traders carrying on the same activity."[1] In addition, importers applying for retrospective approval must also demonstrate there has been no obvious negligence.

[1] *See R1-5 Outward Processing Relief* guidance at http://customs.hmrc.gov.uk.

Mexico

Changes in Mexico's Customs regulations in recent years have greatly expanded FTZ-like programs beyond conventional Maquila operations previously available to importers. The Strategic Private Bonded Warehouse program (the REFIE) has existed since 2003 with benefits similar to those of the U.S. FTZs and the EU PCC program. Under REFIE, goods and raw materials may enter approved sites (these can be private warehouses or warehouses run by state governments) with the deferral of import duties and other taxes. Once within the REFIE, goods may undergo manufacturing, assembly, or other value added services without the payment of duties and taxes.

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Under a pure distribution REFIE environment (as opposed to one that would involve manufacturing or assembly operations), merchandise from abroad may be deconsolidated and inspected and, in some cases, the company may conduct repair, repackaging, labeling, and marking activities to prepare the goods for final sale. For products shipped out of the REFIE, Mexican duty is eliminated entirely. Merchandise returned to vendors, waste, and products destroyed within the FTZ may also enjoy duty elimination benefits in REFIE.

This regime also affords attractive tax advantages. The main benefit consists of exemption of the VAT triggered by sales of goods subject to the REFIE regime. As it relates to income tax, REFIE locations are not deemed to be a permanent establishment for foreign parent companies and, therefore, reductions or exemptions for income taxes may be allowed for activities performed within the REFIE.

Since 2007, Mexico's state government entities have been authorized to administer REFIEs. When dealing with a REFIE that is administered by a state government, the likelihood of obtaining additional tax incentives (e.g., payroll tax exemption or property tax exemptions) increases, since the company may negotiate these types of incentives directly with the state when establishing the REFIE.

Brazil

There are two types of FTZs currently allowed to operate in Brazil: the Manaus Free Trade Zone and the Export Processing Zone. While both are considered to be FTZs, they were established by the government with distinct objectives. The Manaus FTZ offers benefits aimed at encouraging the manufacture of products within the zone for consumption in Brazil's domestic market. The Export Processing Zone provides benefits for companies performing manufacturing and assembly processes for products intended for exportation. Similar to the process in other countries, companies must obtain prior government approval before using either program.

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Manaus Free Trade Zone Benefits

The Manaus FTZ is located in the capital of Amazonas, Brazil's northernmost state. Companies that are approved to operate within the zone must meet a minimum level of manufacturing. This minimum level of manufacturing varies by product and type of operation. Eligible companies enjoy the following benefits (in addition to corporate income tax benefits):

- Exemption from import duties (the II) for raw materials used for the manufacture of exported finished goods and an 88 percent reduction for finished goods entering domestic commerce
- Exemption from industrialized product's tax (the IPI) on imported raw materials and manufactured finished goods
- Reduction of VAT (the ICMS) and gross revenue (the PIS-COFINS) on imported raw materials and manufactured finished goods

Export Processing Zone Benefits

Regulations establishing Export Processing Zones were rectified by the Brazilian government in April 2009. As of today, there are no functioning Export Processing Zones. However, 17 sites have been approved by the government to operate as Export Processing Zones and infrastructure construction has commenced for five of those sites. Similar to the Manaus FTZ, companies must submit an application and be approved prior to operating in an Export Processing Zone.

Eligible companies enjoy exemption from II, IPI, PIS-COFINS, and navy processing fee (the AFRMM) for imported raw materials used in the manufacture of exported items and machinery and equipment installed in the zone and used to manufacture exported items (at least 80 percent of items manufactured by the equipment must be exported).

China

There are several special customs zones that allow importers, exporters, and manufacturers to take advantage of duty and other indirect tax savings in China. These zones include FTZs, Export Processing Zones (EPZ), and Bonded Port Areas (BPA).

While all three of these regimes allow for certain duty and indirect tax savings, each program was established to meet certain objectives. FTZs allow for the most operations to be conducted inside the zone, including simple processing, manufacturing of goods intended for export, and trading between zones, territories, and non-FTZ companies. EPZs have been designated for manufacturing of goods intended for export; however, repairing, testing, and logistics services have also been allowed in all EPZs since 2009. Bonded Logistics Parks allow for simple processing, but do not allow the complex manufacturing conducted under processing trade. Two of these regimes—FTZs and EPZs—are described further below.

To use bonded zones in China, the manufacturer should be a Chinese company, must be located in the zone, and must register the bonded actions with China's Customs authority. Once China Customs authority has approved the bonded activities, the company can begin to take advantage of the duty and cash flow benefits of the zone.

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FTZ Benefits

There are 15 FTZs currently operating in China. In general, these FTZs are located on the eastern and southern coasts of China.[2] Chinese companies that have both domestic and international sourcing can benefit from conducting manufacturing within one of these FTZs. The most substantial benefits of an FTZ are:

- *Duty payment on raw materials only* – When raw materials are imported into an FTZ, by a manufacturer that also sources domestic raw material, the duty owed to China's Customs authority for the finished product (if sold to China's domestic market) will be based on the imported raw materials rather than on the duty rate of the finished good. There will be no duty owed on the locally sourced material.
- *Waiver of duty on raw materials for goods exported from China* – China has a program, called Processing Trade, which allows for importers to claim duty free treatment for raw materials[3] on the condition that they will be later exported. Importers do not actually need to be in an FTZ to conduct Processing Trade operations, but the management of bonded material would be more difficult if the operations are conducted outside of an FTZ.

EPZ Benefits

There are 60 EPZs currently operating in China. Prior to 2007, only substantial manufacturing relating to Processing Trade was allowed in these zones. Since 2007, seven EPZs have been selected as pilots to allow research and development and simple processing. As of 2009, repairing, testing, and logistics services are allowed in all EPZs. The most substantial benefits of an EPZ are similar to FTZs; however, VAT and consumption tax refunds are available to EPZ participants upon entry into the zone. In FTZs, refunds are only available after the goods have been physically exported from China.

[2] FTZs are located at Waigaoqiao, Qingdao, Dalian, Futian, Guangzhou, Shatoujiao, Shantou, Tianjin, Zhangjiagang, Fuzhou, Xiangyu, Haikou, Ningbo, Zhuhai, and Yantiangang.

[3] Some raw materials are prohibited from receiving duty free treatment.

Conclusion

Many countries around the world offer FTZs to companies operating within their borders as a way to reduce and eliminate tariffs, taxes, and other barriers to trade in addition to offering certain supply chain benefits. Multinational companies conducting operations globally can use FTZs to realize these benefits in one or more countries in which these companies import and export products.

From a time perspective, FTZs can take anywhere from one month to one year to implement, as companies must meet the requirements of the local Customs and other government regimes in the countries in which they operate. During this time, companies may incur expenses for setting up the FTZ to meet these requirements and also possibly from implementing an inventory control and recordkeeping system to assist in managing the inventory and corresponding duty savings.

For each FTZ that the company is considering, the company is advised to carefully examine these potential expenses in comparison to the prospective financial benefits from the FTZ implementation. Typically, most companies that choose to proceed with FTZ implementation realize a return on investment within 9 to 12 months of commencing FTZ operations. These benefits could be realized sooner for companies that are considering FTZ implementation in more than one country in an integrated supply chain scenario, as companies shipping between FTZs in multiple countries may prolong deferment of customs duties or may eliminate duties all together.

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Contact Us

KPMG LLP's Trade and Customs Services professionals team can assist your company in analyzing the potential financial benefits and supply chain advantages that your company may realize from operating an FTZ. For more information about FTZs in the United States, the European Union, Mexico, China, Brazil, or any other country in which FTZ programs are available, contact your local KPMG adviser or one of the Trade and Customs Services professionals listed below.

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